

Improving Russia's Policy on Foreign Direct Investment

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Russia gets relatively little foreign direct investment and almost none of the newer, more efficient kind, involving state-of-the-art technology and world-class competitive production linked to dynamic global or regional markets. Why? And what should be done about it?



Summary findings

Foreign direct investment brings host countries capital, productive facilities, and technology transfers as well as employment, new job skills, and management expertise. It is important to the Russian Federation, where incentives for competition are limited and incentives to becoming efficient are blunted by interregional barriers to trade, weak creditor rights, and administrative barriers to new entrants.

Bergsman, Broadman, and Drebenstov argue that the old policy paradigm of foreign direct investment (established before World War II and prevalent in the 1950s and 1960s) still governs Russia. In this paradigm there are only two reasons for foreign direct investment: access to inputs for production and access to markets for outputs. Such kinds of foreign direct investment, although beneficial, are often based on generating exports that exploit cheap labor or natural resources or are aimed at penetrating protected local markets, not necessarily at world standards for price and quality.

They contend that Russia should phase out high tariffs and nontariff protection for the domestic market, most tax preferences for foreign investors (which don't

increase foreign direct investment but do reduce fiscal revenues), and many restrictions on foreign direct investment.

They recommend that Russia switch to a modern approach to foreign direct investment by:

- Amending the newly enacted foreign direct investment law so that it will grant nondiscriminatory “national treatment” to foreign investors for both right of establishment and post-establishment operations, abolish conditions (such as local content restrictions) inconsistent with the World Trade Organization agreement on trade-related investment measures (TRIMs), and make investor-state dispute resolution mechanisms more efficient (giving foreign investors the chance to seek neutral binding international arbitration, for example).
- Strengthening enforcement of property rights.
- Simplifying registration procedures for foreign investors, to make them transparent and rules-based.
- Extending guarantee schemes covering basic noncommercial risks.

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Introduction

As the much-discussed "global market" has become a reality over the last ten years, all countries find it more difficult to stay competitive without FDI. Noteworthy, the most competitive economy in the world, the United States, is not only the largest single source of, but also the largest single destination for FDI. The countries of the European Union are also among the largest sources and destinations of FDI. Among the developing countries, and among the transition countries of both Europe and Asia, the fastest growing ones are the biggest recipients of FDI. The empirical evidence suggests that for emerging economies, a one percentage point increase in FDI (measured as a proportion of GDP) leads, *ceteris paribus*, to an extra 0.8 percentage point increase in per-capita income.¹ Of course, part of the cause-and-effect is that growth attracts FDI. But there are important causation forces from FDI to competitiveness - FDI brings at least four things of value: financial capital, management skills, technology, and access to export markets -- and therefore sustains growth as well.

Russia can and should take full advantage of benefits associated with inflows of FDI. Given the country's large endowment of natural resources and educated labor force, as well as its potentially large market, this might seem as a not too difficult task. Yet the record is discouraging. In spite of explicit efforts by government to lure investors, Russia has received far less FDI than it could, both relative to its economy's size and in comparison with other emerging markets. From 1992-1999, cumulative FDI inflows to Russia total about US\$16 billion. This level of FDI is very low in light of Russia's vast attractive resources—both natural and human—and her great economic potential. It is also very low relative to other transition countries in the region, adjusted for population size: on a per capita basis, cumulative FDI in Russia is US\$15, compared to US\$84 for Poland, US\$118 for the Czech Republic and US\$221 for Hungary. This result implies, in part, a flawed policy strategy regarding FDI.

This paper analyzes Russia's policy regime governing FDI and suggests policies to bring it in line with international practice. We begin with a discussion of how the emergence of globalization has affected the nature of FDI, both from the standpoint of investors and host countries. We then turn to a review of the provisions related to FDI embodied in the WTO, to which Russia is seeking accession. This is followed by an analysis of the current FDI policy framework in Russia. We then present an overview of best international FDI practices. The paper concludes with recommendations for improving Russia's FDI policy regime—stemming both from the necessity to attract cutting edge FDI and to comply with WTO norms.

Globalization and Implications for Competition for FDI

In many transition economies, there is poor comprehension of important changes in a world-wide pattern of FDI over the last two to three decades. The key word for these changes is *globalization* of FDI.

* This paper updates and draws on Bergsman, Broadman and Drebenstov (1999).

¹ See JPMorgan (1998).

“Globalization” is a widely used expression, which covers three main mutually reinforcing processes:

- *Country policies:* More and more countries have continued to liberalize their economic policies over the last decade or two, becoming more open both to trade flows (lower tariffs, fewer quantitative restrictions, currency convertibility) and to FDI flows (fewer restrictions on which sectors are open or percentage of foreign ownership allowed, abandonment of case-by-case approval procedures, etc.). The ones that are not open are experiencing difficulties in maintaining growth.
- *Company behavior:* More and more multinational corporations (MNCs) are adopting integrated regional or even global strategies, using both subsidiaries and strategic allies to locate *interdependent* facilities in various countries so as to maximize their competitive edge worldwide. This is a change from the dominant behavior of 10 or 20 years ago, when MNC subsidiaries in foreign countries were operated more or less independently of each other and were located anywhere there was a market and without regard to whether the locale offered the conditions necessary for world-competitive price and quality production.
- *Technology:* Huge improvements in international transportation and communications, combined with greater use of electronic controls and information storage and transmission, have made the opening of countries, and the change in behavior of companies, viable and important. Computer-aided design and manufacturing (“CAD-CAM”) make it possible to design a product, and the software that will control some of the machines that produce it in one location and have the production process changed and running in another location anywhere in the world in a matter of hours or at most a day or two. Other changes in communication technology have also drastically reduced many of the costs of locating interdependent activities in more than one location.

The changes in technology, behavior and policies reinforce and validate each other. Globalization is a positive-feedback process. Because of this, the world is separating into two kinds of countries: those that offer competitive conditions for production, attract FDI, trade, and experience continuing increases in productivity and hence in incomes, and those that do none of these things and stagnate.

In the course of globalization it has become apparent that international trade and FDI complement each other. Of course in some transactions FDI is a substitute for trade; especially in large markets a foreign company may decide to locate production facilities in the market as an alternative to trying to export from its home country. But in today’s globalizing world, trade and FDI go together. In fact, for many MNCs the edge between trade and FDI becomes thinner and thinner. As one business executive noted at a recent meeting of the OECD Trade Committee: “Firms trade to invest and invest to trade.” Of all world trade, intra-firm trade among MNCs accounts for about one-third, and MNC exports to non-affiliates accounts for another one-third. Thus, only the remaining one-third of world exports does not directly involve MNCs.²

Within this context, the location of the most efficient, up-to-date, competitive facilities is decided more by MNCs and less by arms-length, market forces. As a result, even very large countries find it more difficult to “go it alone.” In terms of economic development it has become very costly for any country, developing, developed or transitional, to be outside this web of globalized production.

² For a discussion of intra-firm trade, see Broadman (1991).

Two other aspects of MNC behavior are also results of the above-mentioned changes in the world economy and forces that validate and increase those changes:

- *Inter-company collaboration:* Spurred by the success of the Japanese *keiretsu*, more and more companies are actively collaborating with suppliers in the design of their products and/or processes, and are taking actions to nurture long-term relations (e.g. less subject to being switched on-off in response to short-term changes in demand or other short-term forces). Just-in-time inventory policy is only a part of this. Some elements of these trends have increased the importance of locating interacting facilities near each other, in opposition to the forces that decrease the costs of distance described above.
- *Intense competition among companies and countries:* The greater openness of national economies and the growing multinational consciousness of businesses have dramatically increased competition in product and factor markets almost everywhere. Comfortable, "quiet life" production at less than world-standard quality and price is a rare luxury for management and labor as well. Prospects for such production have no appeal for MNCs, and today, investors are very reluctant to locate important facilities anywhere that offers them second-class conditions. What MNCs are looking for is a set of policies that simultaneously provide security of market access and nondiscrimination vis-à-vis domestic investors. Partially beneficial policies are not appropriate anymore; for to put at stake state-of-the-art investments, MNCs need to be sure in stability along the whole trade-investment continuum. MNCs do establish facilities in higher-cost or higher risk locations when there are attractive markets; but they are often not integrated into their international strategies, may not have their best technologies, and do not bring the full potential benefits of FDI. Hence keeping a restrictive or even a distorted type of FDI regime prevents an economy from harvesting all benefits associated with the modern-type inflow of capital.

Having a less favorable FDI regime relative to what other countries offer is especially detrimental to the economy because countries compete for FDI among themselves. In the 1950s and 1960s, countries competed for export-oriented FDI but did not have to compete for FDI that was oriented to domestic markets -- just a large market, with protection from imports, was enough. Thus, a country such as Russia would not have offered tax holidays, cheap land, or other incentives.

Today, with globalizing investment becoming more important, even countries with large markets have to compete. Privileges often offered to FDI seem as a natural response to this competition. However, the most effective instruments of such competition do not include tax concessions or other types of foreign investment preferential treatment (see below). Rather a reasonable, transparent and stable tax system is necessary to attract modern FDI; extremely low rates or special treatment is not. Most of the countries that are succeeding in attracting this kind of FDI are in fact not offering such special treatment -- the exceptions are a few Asian countries that have been caught in a bidding war amongst themselves. Russia needs to undertake a comprehensive review of its FDI policy regime and substitute a stability-and-safety package for old-type privileges if it wants to attract today's foreign investor.

Russia's harmonization with the realm of globally operating MNCs is discretionary. But Russia is also acceding to various international economic institutions, of which the World Trade Organization (WTO) is of key importance for shaping national policies towards FDI. Russia, as a nation seeking accession to the WTO, will have no other option but to harmonize its regime with WTO requirements. It is important for the government to have a clear understanding of both those regimes and the inconsistencies with them that current policy presents.

International Agreements and Russia's FDI Policy Regime

The Agreement on "Trade-Related Investment Measures" (TRIMs), entered into by WTO members during the Uruguay Round, has a direct bearing for shaping the FDI regime of a country seeking WTO membership. Acknowledging that certain measures towards investment have apparent restrictive or distortive implications for international trade, the TRIMs Agreement stipulates that no signatories shall apply any TRIM inconsistent with the Article III and Article XI of the GATT 1994.

Fleshing this out, the Appendix to the TRIMs Agreement lists some types of prohibited TRIMs. Among such measures, be it a mandatory requirement or a prerequisite for obtaining some privilege, are:

- (i) those that require particular levels of local sourcing by an enterprise - "local content requirements";
- (ii) those that restrict the volume of imports which an enterprise can buy or use to the volume or value of products this enterprise exports - "trade balancing requirements";
- (iii) those that restrict the volume of imports to the amount of foreign exchange inflows attributable to an enterprise - "sufficient foreign exchange earning capacity requirements"; and finally
- (iv) those that restrict exports by an enterprise either in terms of the particular type of products (or their volume or value), or, generally, in terms of a proportion of local production - "supply to local market requirements."

It seems at the moment that the second and the third clusters of potential non-compliance are not relevant to Russia. Indeed, there are no such restrictions in existence so far. Yet as we show below, Russia is a clear case for both the first and the fourth groups of inconsistent TRIMs. It is particularly so if one bears in mind that, as the above text indicates, prohibited TRIMs include not only explicit bans or restrictions, but also any condition of a nature described in one of four clusters above that is necessary to comply with to obtain an advantage.³

Another item that is critical with respect to the TRIMs Agreement pertinent to Russia is as follows: the Agreement requires the mandatory notification of all non-conforming TRIMs covered by the above list (whether they are implemented at the federal or sub-national level), and calls for elimination of such TRIMs over a transition period. The transition period varies according to a country's status. Since Russia has, to date, notified the WTO Secretariat that it is going to accede to this organization as a developed country, the transition period will be just two years, in contrast to the five years granted to developing countries. Similarly, neither potential extension of the transition period nor an allowed deviation from the provisions of the TRIMs Agreement, that are available to developing countries, could be utilized by Russia.⁴

³ The term "advantage" is not defined in the TRIMs Agreement. However, it is understood to cover all forms of preferential treatment, including tax-based or interest rate-based ones.

⁴ Unavailability of the latter temporary deviation acceptable to WTO, if carried out by a developing country for balance-of-payments purposes, seems to be a particular loss for Russia given persistent attempts by the authorities to introduce language on trade restrictions for balance-of-payments purposes into the national

Apart from the WTO, there was, until recently, another proposed international agreement on FDI: the Multilateral Agreement on Investment (MAI) -- the OECD countries' initiative. Although negotiations for the MAI have been suspended, when and if it comes into existence, the MAI would replace the current world-wide network of bilateral investment treaties (BITs)⁵, regional agreements and OECD-type vehicles (Codes of Liberalization or Declaration and Decisions on International Investment and Multinational Enterprises).

Russia's FDI Policy Regime: Achievements and Challenges

It should be acknowledged that Russia has been constantly and explicitly trying to attract FDI, and hence make the FDI regime more attractive. However, a relatively small amount of accumulated FDI suggests that the government has not been very successful. Of course the lack of political and economic stability has been an important stumbling block and even a first class policy towards FDI would not suffice to outweigh that. While acknowledging the importance of macro stability, nonetheless, Russia's FDI regime has significant flaws.

The most serious challenge Russia faces at the moment is to switch from an obsolete approach towards luring foreign direct investment to modern one. The former, in the case of Russia, involves relatively high tariff protection of the domestic market, and on top of that, specific privileges offered to FDI. The latter approach would require getting rid of both these sticks and carrots, and providing foreign investors with a generic climate conducive for attracting cutting-edge capital. We will come back to this issue. Let us start with a review of specific problems of the Russian FDI policy regime.

TRIMs Inconsistent with WTO Rules. The first and the smallest cluster of such problems comprises procedures inconsistent with the TRIMs Agreement. The government has notified the WTO Working Party of just a single prohibited TRIM so far. Moreover, the government has stated that even that TRIM is not implemented. Indeed in December 1997 the government submitted to the WTO Secretariat an Addendum "Regime in the Area of Trade Related Investment Measures", which claims that while "[the] Russian national legislation currently in effect contains no general trade-related investment measures inconsistent with the requirement of the TRIMs Agreement", the Chapter II of the Federal Law "On Production Sharing Agreements" (PSA) contains the following language:

Grant Russian legal entities, all other factors being the same, a preferential right to participate in the performance of operations under the [Production Sharing] Agreement as contractors, suppliers, carriers or otherwise... The Parties shall stipulate in the Agreement that at least a certain portion of the basic equipment for mineral production and processing... to be purchased by the investor with subsequent cost recovery out of compensatory share of products shall be manufactured within the Russian Federation.

The government has stated that "for full implementation of this law, the adoption of additional normative legal acts is required", and that no actual contracts signed so far under an umbrella of the PSA legislation contain conditions specified in the law.

legislation and other normative acts. Accession to WTO would make these attempts useless for Russia will not be permitted to use this excuse.

⁵ Today, there are over sixteen hundred active BITs entered into by various countries.

At least three additional TRIMs Agreement inconsistent measures have been contemplated by the Russian authorities in 1998. Even in 1997, when notification was submitted, the PSA law did affect actual agreements -- if not yet contracts -- of partners involved in deals covered by the PSA legislation. Two examples are the Prirazlomnoye and Sakhalin-1 oil field projects. In the former case, the Russian government issued a decree explicitly naming a Russian producer (Sevmash company) the main equipment supplier for the project. In the latter, the agreement states that at least seventy percent of equipment for the project shall be procured from Russian producers. These requirements constitute a clear case of the first-type TRIMs prohibited in the Illustrative List annexed to the TRIMs Agreement.

The realm of PSAs does not constitute the sole example of WTO-inconsistent TRIMs. The Federal Law "On Privatization of the State Property and on Principles of Privatization of Municipality's Owned Property in the Russian Federation", approved on July 21, 1997, contains the following TRIMs Agreement inconsistent language (Article 21.5):

While selling privatization objects at a commercial tender, there might be established an investment condition in a form of a winner's obligation to carry out prescribed measures for tariff and non-tariff protectionism of the Russian producers, including procurement of the Russian raw commodities, materials and semi-processed goods...

Moreover, on April 23, 1998 the Government issued Resolution No. 413 "On Additional Measures to Attract Investment for the Development of Domestic Automobile Industry", which *inter alia* establishes an explicit link between granting an investor the right to import under the "Free Warehouse Customs Regime" -- an exemption from paying import duty on any imports used in a project by an investor -- and "share of costs incurred on the territory of the Russian Federation." In view of the earlier comment that TRIMs Agreement inconsistent measures include not only mandatory ones, but also those conditions that are prerequisites for obtaining an "advantage", such a "local content" TRIM constitutes a clear breach. Similar infringement of the TRIMs Agreement will be established by another government Resolution. That Resolution creates a direct link of government's approval of the national air carrier Aeroflot's purchases of foreign made aircraft to its purchases of domestically produced airplanes (in proportion of one imported plane per four Russian-made ones).

Another apparent example of TRIMs Agreement inconsistency has been recently created by the national quasi-state bank, Sberbank,⁶ which announced a lending policy in mid-1998. It started to grant preferential interest rates on commercial loans to companies purchasing Russian-made products (24 percent vis-à-vis 27 percent for purchases of imported goods), which again falls under the first-type of prohibited TRIMs.⁷

Finally, resolutions falling in the fourth group of prohibited TRIMs are issued from time to time. The most recent examples were resolutions establishing an export quota or a temporary export tax on exports of fuel oil. It was also reported the Prime Minister ordered oil companies that did not honor agreed shipments to domestic agricultural consumers would be deprived of access to export pipelines. Such measures are typically considered to be TRIMs Agreement inconsistent.

⁶ Sberbank is formally a commercial bank, yet it is predominantly owned by the Central Bank of Russia.

⁷ In fact, even if there were no TRIMs Agreement, this measure would still be considered WTO inconsistent, for this is exactly a type of measures prohibited not only by TRIMs Agreement, but also by an earlier Agreement on Subsidies and Countervailing Measures.

General Problems of the FDI Regime. Although the above problems are significant, they should not pose a difficult dilemma for the Russian authorities. Indeed, if Russia is keen on WTO accession, the government has eventually no choice but to face the necessity to eliminate inconsistent TRIMs. It is not as simple with other peculiarities of the Russian FDI regime, where government agencies exercise much greater discretion, and hence, might consider changing the current approach only if convinced that revisions would serve Russia's interests. This is a much bigger cluster of problems than the previously discussed ones. For simplicity of analysis it is convenient to divide it into two groups: (i) remaining excessive restrictions on FDI, and (ii) unnecessary privileges granted to FDI.

Restrictions on FDI. Many countries have restrictions for FDI in sectors considered strategic, either in terms of national defense or economic stability (financial sector), or vital for preserving national identity (most commonly, culture and mass media). Formally, Russia does not deviate significantly from this pattern. The Federal law establishing the set of activities with banned or restricted FDI does not look completely unreasonable. In fact, in the first list attached to this law -- which establishes activities *prohibited* for foreign investors -- there are only a relatively few areas. The second list attached to this law -- comprising activities with *restrictions for FDI* -- is more problematic. On top of military-related or dual technologies, it includes (i) many infrastructure sectors -- (a) federal electric energy distribution systems⁸, (b) communications, (c) marine transportation, (d) aviation, (e) railroads, (f) civil airports construction, (g) highway maintenance and surveillance, etc.—as well as (ii) production of maps and globes, (iii) pharmaceuticals, (iv) ethyl alcohol, (v) alcoholic beverages, (vi) specialized investment funds, (vii) land research and development, (viii) auditing, among many other sectors. It is difficult to rationalize the need to restrict foreign investors' participation in many of these activities, particularly given that many of these sectors desperately need an injection of modern technology or managerial skills that FDI brings in.

With regard to restrictions in Russia's financial sector, many countries have restrictions of this kind. Still, the current ceiling for foreign capital in (ix) banking -- 12 percent -- might be increased without a real threat to national banking independence while contributing to enhancing efficiency of banking services. The latter is particularly important at the current stage of market transition in Russia, where resumption of economic growth is hampered in part by the lack of efficient financial intermediation for domestic savings and by the shortage of affordable commercial credit to the real sector. The same is true with respect to (x) insurance, where direct activities of foreign owned companies are entirely prohibited, and foreign ownership is limited to 49 percent of Russian insurance companies' charter capital.

The next layer of restrictions is associated with the State Privatization Program (SPP), which is approved on an annual basis. The current draft SPP is more liberal towards FDI than its predecessors. It reduces several types of previous restrictions and limitations -- like discretion of local authorities to allow foreign participation in privatization of medium and small companies, the right of the Federal Security Service to recommend annulling results of privatization auctions if it has objections to a foreign winner, and so on. This liberalization is rooted in the federal law establishing lists of sectors where FDI is either banned or restricted.

Preferential Treatment of FDI. Simultaneously with considering easing most of the above restrictions, the government should eliminate specific privileges offered to foreign investors. One of them is free customs warehouse imports. In addition to that, the government grants import duty

⁸ An example of exercising this right was the passage by the Duma of a law establishing a 25 percent ceiling on foreign ownership of RAO UES shares.

exemptions. The most recent example of the latter is a decree that slashes by a half all import duties due on shipments of those foreign companies that will bring over \$100 million in investment into the country.

There is much cross-country evidence that tax concessions are not only inefficient mechanisms for facilitating FDI, but they are *quite costly to the fiscal balance—an obvious point that cannot be over-emphasized in the Russian context*. In fact, a lot of countries that in the past have experimented with this approach to attract FDI, including Indonesia, Morocco, Romania, Latvia and China, have since started to phase out tax preferences for FDI.⁹ The Russian government, whose finances—absent high oil prices—would be under enormous pressure, has even more incentives to follow that path. The same is relevant to Russia's Special Economic Zones. Most of them have never moved further than just being established by a decree. Yet three that have become operational -- Ingushetia, Nakhodka and Amber ("Jantar", Kaliningrad) -- arguably have engendered more abuses and distortions than advantages.

Indeed, as early as 1992 the World Bank's Foreign Investment Advisory Service (FIAS) warned the Russian authorities that "if the special [tax] treatment goes only to foreigners, then there will be... the formation of hundreds and then thousands of false joint ventures or foreign-owned companies, in which local entrepreneurs find friendly foreigners to lend their names to enterprises and thus reduce tax liability."¹⁰ Serious foreign direct investment is not primarily attracted by tax concessions, nor by the same token inhibited by reasonable tax rates. What matters more is consistency, transparency and predictability of the tax system. Indeed, the authorities' own analysis of foreign investors' complaints about Russian taxation highlights the problems of instability, inconsistency and non-transparency.¹¹

Of much higher priority to foreign investors relative to tax breaks is an ability to present an appeal on rulings by the tax service without suffering up-front fines and levies, and, in case amicable resolution is not possible, the ability to apply to an efficient dispute settlement mechanism. The lack of independent and efficient arbitration is one of the main stumbling blocks for FDI in Russia. This is particularly so given the sheer number of overlapping regulations and numerous inconsistencies between various laws and other normative acts, such as Presidential Decrees, Internal Directives of the government and ministries, federal and local procedures, etc. This muddle does not contribute to building foreign investor's confidence. An example of what this incoherence causes for the country occurred in May 1998 when parliamentary passage of restrictions on foreign ownership of RAO UES contributed significantly to turmoil on the Russian financial market.

The latter issue raises another important barrier faced by foreign investors in Russia. This is "red tape" involved in foreign investor activities. It starts with registration procedures that are openly considered by investors as one of most cumbersome processes in the world. Instead of being a one stop-low burden exercise, an investor obtaining government approval faces the necessity of getting clearance by at least 5 to 6 ministries and agencies, which takes from 3 to 6 months".¹² Of course domestic investors have to deal with a lot of red tape, too. But putting additional burdens on foreign investors, who by definition face distinct disadvantages in carrying out business transactions in a different culture than their home turf, seems counter-productive. It is

⁹ For analysis of the FDI policy regime in China see Broadman and Sun (1997).

¹⁰ FIAS (1992).

¹¹ See for example Foreign Investment Advisory Council (1994).

¹² For details see *Foreign Investment in Russia: Trends and Prospects* (1995).

certainly contrary to the notion of “national treatment.” Clearly, comprehensive simplification of business registration/licensing procedures would generally be conducive to development of Russia’s market economy.

International Experience in Reforming FDI Policy Regimes

The *old paradigm of FDI*, established before the Second World War and seen all over the world during the 1950s and 1960s, still characterizes FDI in the Russian Federation today. In this paradigm, there are essentially only two motivations for foreign direct investment: access to some inputs for production, and access to markets for outputs. The inputs that attracted investment were varied, including natural resource deposits, low-cost labor, and lesser ones such as good climates for tourism. The attraction of inputs continues to be important to this day although the importance of low-cost labor is decreasing. Countries that were strong in one or both of these attractions received a lot of FDI, even if their political, legal, or economic conditions were second-rate. Countries without large and growing markets, and without natural resources or very cheap labor, were not important destinations for FDI. Brazil, for example, received relatively large amounts of FDI during the 1950s and 1960s, almost all aimed at producing for the large and protected market, and most of it manifested in high-cost, low-productivity facilities that would never export and were not intended to strengthen their parent companies in any significant way.

These two kinds of FDI also differed sharply in their relationship with trade. Input-seeking FDI greatly increased trade and in fact was dependent upon it. Market-seeking FDI was a substitute for trade and in many cases depended on trade restrictions. Most FDI in those days was “greenfield” investment – that is, it was embodied in the construction of new factories.

Global flows of FDI have tripled in the last ten years, while those flows to developing and transition countries have increased by a factor of 10. A significant part of this explosive growth has not been in greenfield activities but rather in mergers and acquisitions (M&A). Inward M&A in the developed countries – mostly the European Union and the US – has been running at 40 to 60 percent of inward FDI during the 1990s, and in the transition countries of Central and Eastern Europe, the ratio has been about 50 percent. The dominant motivating force behind this M&A activity has been to rationalize and strengthen the competitive edge of the investing company by giving it facilities for global or regional strategies of creating interdependent production, administration, research and development, accounting, design, and other parts of its business. Of course, some additions to physical capacity usually follow these mergers and acquisitions. But the driving force is the search for corporate-wide (i.e. worldwide) efficiency and competitive advantage. Sheer large markets do not suffice to attract this kind of FDI. Hence, unfortunately, not much of it is seen in countries such as China or Russia.

In this *newer paradigm*, almost all FDI is complementary to trade. Brazil, which received US\$16 billion in FDI in 1997, has experienced increasing FDI that integrates it into multinationals’ international production strategies. Already several years ago, Ford engines were made in Brazil, exported to Canada where they were assembled into finished automobiles, and then sold in the United States. In March of 1998 Ford announced plans to build two of its new “world car” models in Brazil, which will require new investment of around US\$1 billion before the end-2000. This is in addition to the \$2.5 billion they had already planned to invest in Brazil. Ford plans to build on its domestic sales base to use the country as its base for exporting not only to the Mercosur region (neighbors in South America) but also to other continents. This is the kind of foreign direct investment that most strengthens economies into which it goes, and that provides the best foundation for continuing increases in productivity and income. The \$10

billion of FDI that Brazil received in one month in 1998 is about equivalent to the FDI Russia has attracted in the seven years 1991-1997.

Other reforming countries are also attracting this internationally linked FDI: Ninety percent of all television receivers sold in the United States are made in Mexico, almost all of them by subsidiaries of multinationals from Japan, Korea and other Asian economies. Hungary is one of the world leaders in attracting FDI without natural resources or particularly cheap labor, and this FDI has sparked enormous growth in exports of high- and medium-tech manufactured goods, especially machinery and equipment, and machine parts. Costa Rica has similarly attracted a lot of high-value FDI, including recently an Intel chip assembly and testing plant; Costa Rica has higher wages than Mexico or its neighbors in Central America, but attracted Intel with its rule of law and strongly facilitating investment climate.¹³ The *Annex* presents a detailed analysis of the sequence of economic reforms undertaken by Mexico, and the results in terms of both quantity and kinds of FDI that were attracted.

Conclusion and Policy Recommendations

There is a short set of characteristics that determine which countries are part of the global web of FDI and multinational production. These elements of attractiveness have changed a bit over the last couple of decades as globalization has taken hold, but basically derive from first principles of economics. An up-to-date list would now include the following items:

- political and economic *stability*, to provide reasonable predictability for making business decisions;
- government behavior that *facilitates* doing business, rather than harassing it;
- an FDI *legal framework* in line with best international best practice, with *security of property and of persons* and *enforceability of contracts*;
- an enabling environment for *domestic* market growth, including adequately developed physical infrastructure networks and well-trained workers; and
- the availability of all these conditions to *all* companies *automatically* and by *law*, i.e. *rules-based*, without a need for special treatment, particular deals, or discretionary decisions by either elected officials or civil servants.

This last point—a *rules based* FDI policy regime—is key. It is one of the reasons why Russia's accession to the WTO is so important. Indeed, accession to the WTO will certainly be a positive step for Russia. It would be both an actual and symbolic step towards Russia's harmonization with international economic policy practices and bring it in line with the new paradigm of FDI. As noted above, it would

¹³ For an analysis of why Intel chose Costa Rica, see Debora Spar (1998). The conclusion says, in part: "*What drew Intel to Costa Rica, and what was vital in convincing the company to invest, were the basic characteristics of Costa Rica's political and economic system. The country is a democracy, it is stable, it is liberal, and generally committed to economic openness and progress. Its government's attitude toward private enterprise is basically facilitating, rather than harassing. It also has a fully transparent legal system... Note the other locations of Intel's largest overseas facilities: Ireland, Israel, Malaysia. While clearly different in many respects from Costa Rica, they share a common pool of political and economic assets. They are stable, democratic, and relatively free of the corruption and legal fluctuations that plague many of their neighbors...*"

require Russia to bind itself to avoid many practices that impede investment as well as trade, and to take other positive steps that will attract high-quality FDI. The simultaneous or closely coordinated formulation of trade policy and FDI policy is an important step forward for Russia.

In this respect it is worth noting that in its 1996 *World Investment Report*, the United Nations Program on Transnational Corporations analyzed the new paradigm and concluded:

The decision to locate any part of [a company's operations] wherever it is best ... means that FDI and trade flows are determined simultaneously. They are both the immediate consequences of the same locational decision... [This] presents new challenges for national policy makers. The need for coordinated policy approaches acquires greater importance... National trade and FDI policies have typically evolved separately, frequently influenced by different goals, and administered by distinct, often loosely connected agencies. This ... separation is not suited to a world in which trade and FDI are closely interlinked. (pp. xxiv-xxvi)

Beyond the *basic* conditions enumerated above, a good investment climate for a country such as the Russian Federation is made up of many *specific elements*. There will be a payoff from improving conditions for every kind of business, and for business generally.

One of the most damaging elements is the tax system, in which instability, a heavy burden, and arbitrary enforcement are a major deterrent to foreign investors. The recently passed portion of the Tax Code will help in this regard, but more needs to be done. Repeated efforts to amend or change the June 1991 law on FDI are another source of serious uncertainty for investors. That law, while it has its weaknesses, is not a major impediment to FDI; the recent amendments to that law, however, are a step backward.

There need to be stepped up efforts in dealing with crime, corruption, lack of security of property and persons, and enforcement of contracts. This multifaceted problem, for foreign investors and Russian citizens and companies alike, is getting worse rather than better. It is a major deterrent to FDI, and especially to cutting-edge, world-class FDI facilities. Even when appropriate legislation exists, the courts are unable to enforce procedures and outcomes. It is important to strengthen the legal/judicial framework to allow for credible property rights and adequate contract enforcement.

Many countries have paid increasing attention to the problem of corruption, and the debate on possible policy options is on-going. There is no single solution.¹⁴ Recent insights suggest that corruption arises when institutions have monopoly positions, there is the ability to exercise discretion and incentives for accountability are weak. Additional laws themselves are unlikely to bring about significant reduction in corruption. Effective reform must be directed to changing the system: (i) introduction of independent oversight of agencies; (ii) clarifying and making transparent how much official discretion can be exercised; and (iii) utilizing penalties and rewards for conduct. Russian authorities should give consideration to establishing independent anti-corruption oversight ("watchdog") bodies at the federal and regional levels; models can be found in other countries, such as Hong Kong, Singapore, Botswana and Chile. These two sets of problems are so severe that most actions on other elements of the business climate that the Federation Government (including the Duma) might take will probably not succeed in attracting much more FDI, with the exception of production sharing agreement legislation for the exploitation of minerals and hydrocarbons.

¹⁴ See, for example, R. Klitgaard (1998) and C. Gray and D. Kaufmann (1998).

Rules-based, streamlined business licensing at the Federal and local levels needs to be put in place. Measures are needed to address the problem that the setting of license fees is subject to the discretion of local authorities, which results in price discrimination and arbitrary rule. Reforms here are a top priority.¹⁵ They should be based on other countries' experiences and on enacting legislation that sets precise, streamlined limits at all levels of government on the time and money required to get a business license in most sectors, and codifies sizeable criminal sanctions for officials who violate this rules-based system. For certain sectors, such as human health, the environment and national security, more stringent procedures could be applied.

The industrialized countries have large markets, and they also provide the conditions described above. That is why they receive over two-thirds of all FDI flows -- in spite of generally high labor costs, high tax rates, and other factors often said to repel FDI. Brazil, Mexico, Hungary, the Czech Republic, and Poland are examples of other countries, large and small, that are providing the right conditions for production and trade and thereby attracting efficiency-seeking investments. A few other small countries, such as Botswana, Costa Rica and Estonia, have created a competitive advantage for themselves where none existed in nature, by developing business-friendly laws, regulations, and administrative practices. Within the Russian Federation, regions such as Novgorod, Nizhny Novgorod, Vladimir, Samara, Ekaterinburg, Kazan, and Novosibirsk have done the same thing -- attracting investors by creating better business conditions.

The inherent attractiveness of Russia as a place for foreign direct investment means that Russia does not have to be perfect on every item discussed here. Moreover, the necessary improvements would be just as beneficial for Russian companies as for foreign-owned ones. The single most important task is to create a decent environment to do business honestly and efficiently.

Overall, for Russia to switch to a more modern policy approach to FDI, three core pillars of the current FDI policy regime will have to be reformed -- (i) eliminating the relatively extensive non-tariff protection given to the domestic market, (ii) phasing out existing tax preferences for foreign investors, and (iii) reducing significantly restrictions on FDI to a limited number of activities.

The following are specific high priority reforms that are needed to bring Russia's FDI policy regime up to best international practice:

1. The federal law "On Foreign Investment" should be amended to ensure that it will (i) grant non-discriminatory, "national treatment" to foreign investors for both right of establishment and post-establishment operations; (ii) prohibit the imposition of new and the phase out of existing trade-related investment measures (TRIMs), e.g., local content measures, export performance requirements; restrictions on use of foreign exchange; trade balance measures, including those prohibited by the WTO, among others, on foreign direct investment; (iii) provide freedom to foreign direct investment projects regarding all investment-related transfers, e.g., profits, royalties, the right of compensation for confiscation, requisition, and other guarantees; (iv) provide for binding international arbitration for investor-State disputes; and (v) abide by international law standards for expropriation, i.e., expropriation only for a public purpose and with prompt, adequate and effective compensation.

¹⁵ The general problem of the lack of a competitive business environment in Russia is analyzed in Broadman (2000).

2. Legislation should be enacted to substantially reduce over a phased period in a time-bound program both (i) the number of sectors where FDI is presently prohibited and (ii) the number and incidence of existing limitations on FDI in sectors where it is permitted but restricted. Such measures should cover not only manufacturing sectors but also the infrastructure monopolies sectors and services sectors.
3. The Government should refrain from creating – and not supporting legislative initiatives for establishing – new preferential measures, including policies in the areas of taxation, customs duties, among other instruments, for FDI, including the creation under law of new “priority” sectors or projects. At the same time, the Government should take all necessary actions, including seeking enactment of legislation where necessary, to ensure that all existing preferential instruments for current FDI projects are not renewed and thus terminate concurrently with existing contracts.
4. Enforcement of property rights should be strengthened.
5. Foreign investor registration procedures should be simplified, rules-based, and made transparent.
6. Guarantee schemes covering basic non-commercial risks should be maintained and extended.

ANNEX

LIBERALIZATION AND THE ATTRACTION OF “GLOBALIZING” FDI: THE CASE OF MEXICO

A New Kind of Foreign Direct Investment. The last 10 or 15 years has seen the rise of a new kind of foreign direct investment (FDI). The two older, still-extant paradigms are (a) market-seeking, and (b) resource- or cost-reduction seeking. The new, third kind can be called (c) “globalizing,” and has the following characteristics:

- Especially within the manufacturing sector, most of it is not focused only on either local resources (i.e. cheap labor, climate, raw materials) or domestic markets, but rather is looking for a combination of both market access and cost-effective production. Much of it has significant shares of its sales both in export markets and in the market of the host country.
- A fair amount of it has been implemented in transactions in which mergers and acquisitions (M&A), including privatizations, played a major role -- rather than greenfield activity. This characteristic is especially marked in FDI among the developed countries and may be less common in the LDCs. Of course most M&A deals are followed by some greenfield; the distinction can get a bit fuzzy.
- None of it is “stand alone” – i.e. it is not an independent profit center that is permitted by the MNC headquarters to more or less do as it sees fit, independently of the rest of the organization, as long as it makes a profit. Rather, it is part of a strategic plan by one or more multinationals to optimize locations of various parts of one or more production chains that have production locations in various countries and markets in various (same and/or other) countries. This “plan” may be internal to one MNC, to get or maintain a competitive edge in some final or intermediate markets, or it may be a coordinated plan of more than one MNC, with some sort of strategic alliance, tacit or explicit, among them. The best single empirical distinguishing characteristic may be that the location decision in question depended on other location decisions.
- Labor intensive activities fall within this globalizing FDI if the labor in question is highly educated and highly skilled, and the activity is closely linked with other operations of the MNC. A lot of this is in what are *de facto* service activities, although some are in companies that are clearly service companies while other are service parts of manufacturing companies (e.g. engineering or software design of manufactured products). Thus, writing computer code in Bangalore or designing high-pressure boilers for electric power generation plants in China should be included.

Globalizing FDI will not go to second-best locations (however defined) because its companies operate under severe competitive pressures that in effect do not permit second-best locations. Since very little globalizing FDI is tied to any one country – although it may be tied to a region – it is free to avoid unfavorable locations. In operational terms, and in addition to the characteristics of a good investment environment that are described in the main text of this paper, globalizing FDI in particular wants:

- An absence of restrictions and requirements and harassment by government, especially on entry (i.e. establishment of foreign-invested firms), imports, exports, percentage foreign ownership, employment of expatriates, and local procurement. Restrictions both on establishment and on

operations are important; globalizing FDI requires flexibility to alter its mode of production, process, and sources of procurement, without having to get time-consuming or risky government permission.

- High-quality transportation and telecommunication links with the rest of the world.
- Some kind of minimal quality-of-life; e.g. absence of significant crime/corruption.

Both of the older kinds of FDI still operate and can be quite valuable for a country to attract. But the globalizing FDI is the main kind that serves dynamic markets, and is automatically high-productivity. It is therefore the most valuable kind to try to attract. World Bank (FIAS) research and experience suggest that only about a dozen developing and transition countries are attracting significant amounts of globalizing FDI.

The Case of Mexico. Throughout the 1950s, '60s and '70s the Mexican economy grew steadily, with exceptional macroeconomic stability and an import-substitution strategy. Its large market limited the inefficiencies inherent in this strategy, as did its long border with the United States, which kept protection levels below the extremes of some South American countries that also erected high barriers to import competition.

FDI came to Mexico mainly to serve the domestic market. High production costs, the result of both natural factors such as deficient infrastructure and poorly educated workers and also policy-imposed factors such as domestic procurement requirements, were passed on to Mexican consumers, and most foreign-invested companies did not export – indeed, they could not be competitive in export markets. The exception was the *maquiladora* industry, which began as simple labor-intensive assembly of garments and electrical assemblies; parts were imported from the US and products re-exported to the US, under a provision of US law that limited duties to the value added in Mexico.

Petroleum, petrochemicals, all infrastructure services, banking and finance, and many other sectors were closed to foreign investors. Except for the *maquiladoras* and the automotive industry, foreign investors were restricted to less than 50 percent ownership of a company (in some sectors, less than 40%), and this severely limited FDI in contrast to countries such as Brazil where no such limitations were imposed. The ownership restrictions were especially important impediments to high-tech, cutting edge technology, and globalizing FDI that needs to export, because multinationals do not want to share their best technology with foreign partners that are forced upon them, and cannot plan to supply export markets competitively if they cannot assure production at world standards of quality and price.

Increasing inflation in the 1970s, the first devaluation in 25 years in 1976, and the exhaustion of import substitution possibilities ended this era of stable growth. Explosive growth in hydrocarbon exports, which began in the 1970s, turned out to be more a curse than a blessing as Mexico's fiscal and exchange rate policies were allowed to deteriorate in a wave of excessive overconfidence. With the debt crisis of 1982, the need for a new approach became acute and obvious to all.

Mexico implemented macroeconomic reforms beginning in August 1982 in order to reduce inflation, service its restructured debt, and stabilize the economy. The balance of payments problem was solved, in a static sense, very quickly although with much pain. But it soon became clear that to resume growth Mexico would need to complement these reforms by a more liberal trade and investment regime - consistent with the global operations of multinational firms, and indeed to provide the appropriate framework for Mexican-owned firms to attain international competitiveness as well. As the economy recovered in the mid-1980s, trade barriers were eliminated, both imports and exports rose, and FDI

became essential -- not only to finance the external deficit, but mainly to increase efficient export capacity and employment.

Following the trade liberalization in the mid-1980s, the first move to liberalize FDI came in 1989. By then it had become obvious that the most dynamic trade flows were generated by multinational firms who would specialize in the production of one or a few products, not only selling them in Mexico but also exporting them to the world. Such operations required the freedom to import, expand capacity, and change products or processes without restriction or even delays while awaiting government approval.

New regulations on foreign investment, issued in 1989, were drastic modifications in the restrictive law which dated from 1973. The regulations liberalized FDI establishment in several ways, and were complemented by liberalization of regulatory practice that was just as important, even though it was informal. Formally, majority Mexican equity was no longer required, except in a few sectors such as banking, oil, and electricity, if a proposed investment met certain criteria. In practice virtually every normal investment was deemed to meet these criteria, and permission was given automatically and quickly; the only exceptions were undesirable or truly sensitive activities such as toxic waste dumps, gambling casinos, weapons assembly, nuclear technology, etc. The regulations also simplified the registration procedures for foreign investors, and removed or simplified restrictions and red tape that had previously been involved in government approval of various aspects of technology transfers.

Foreign investments that were within the restrictions on percentage ownership had not, and still did not, need government approval -- they were treated as Mexican companies in every way. But for foreign investments that wanted to exceed the limits, it had been possible, and still was possible, to request an exemption. This exemption was granted (or refused) by an inter-ministerial body called the National Foreign Investment Commission (*Comision Nacional de Inversion Extranjera* -- *CNIE*). Under the new regulations, the *CNIE* only had to rule over a much smaller number of exceptions to a much more liberal regime. Procedurally, the *CNIE* stopped its practice of detailed evaluation of requests for exemptions, with bargaining on conditions and, sometimes, refusal. Instead, it processed applications routinely and approved virtually every request, without imposing conditions, with the few exceptions noted above.

As to technology transfers, the former practice whereby the Ministry of Industry had to approve all contracts for technology transfers was abolished. The Ministry's practice had been to evaluate these contracts and in many cases to substitute its judgment for that of the Mexican companies, both in regard to whether the particular technology was or was not appropriate, and in regard to the price paid (royalties, etc.). Mexican private companies, the supposed beneficiaries of this practice, were the loudest voices against it, and as of 1989 the practice was discontinued.

Overall, the change in Mexico's attitude toward FDI went far beyond the change in regulations. The Government's basic attitude switched from suspicion and regulation, to promotion and facilitation. As another part of the implementation of this change, the Government created a new autonomous agency, the Mexican Investment Board, to promote FDI in Mexico. "Supported half by the government and half by the private sector, the MIB has the task of attracting desired investment to Mexico and facilitating the paper work of foreign investors with regulatory authorities, including those at the provincial government level.

These reforms, plus some recovery in domestic demand in the second half of the 1980s, brought increased FDI flows, but only in 1989 did the amount reach \$3 billion and in 1990 it fell by 10 percent. Thus the government realized that its new FDI regulations and more liberal procedures were not enough

to attract foreign capital in large amounts. The next step was NAFTA, the free trade agreement with the US and Canada.

NAFTA negotiations started in 1991. For Mexico the main objective of this "free trade" agreement was in fact not free trade but rather to attract more world-class FDI. Mexico already had very good access to US markets, except for a few products where restrictions remained even under NAFTA.

The investment dimensions of this trade treaty were both explicit and implicit. Explicitly, NAFTA was the first trade agreement to contain wide and specific regulation on investment. In particular, the 'national treatment principle' commits the Government to guarantee to a North American investor treatment which is just as good as it gives to the national. NAFTA also removed restrictions in sectors which the 1989 regulations had left protected, such as car parts, banking, and electricity generation. Beyond these explicit provisions, NAFTA made it much more difficult for future Mexican governments to reverse the liberalizing reforms of the mid- and late-1980s. By locking in those reforms, the agreement greatly reduced uncertainty over the regulatory framework, as well as over market access to North America. This was another necessary dimension of a Mexican environment that would attract globalizing FDI.

The automobile industry shows how FDI in Mexico changed with globalization. Created in the 1950s, the industry for the most part produced high-cost cars and trucks of less than up-to-date technology. Some parts were imported, but more and more were made in Mexico as the government imposed domestic content requirements on the assemblers. The auto assembly industry was not subject to restrictions on foreign ownership, but had to meet requirements for buying parts within Mexico. In the auto parts sector a 49% restriction on foreign ownership remained in place, protecting Mexican-owned auto parts producers. This last restriction is now in a seven-year phase out period under NAFTA.

Beginning in the 1970s, even before the liberalization, a search for economies of scale led to the appearance of a few auto parts producers, some with foreign investment, which sold both to assembly plants in Mexico and also to assembly plants in the United States. Until the late 1980s, however, such instances were rare.

With the changes that began in the mid-1980s, automotive exports have grown rapidly, and imports have also increased as an extensive network came into existence in which products and components are traded worldwide, but especially between Mexico and the US. The export of components, including high-tech parts such as engines and transmissions, was a result of major new investments made in new plants in Mexico by Ford, General Motors and Nissan. These investments represented a change from previous investments by the same firms, in that the recent ones were designed to play a specific role in the global strategy of the parent company, supplying their worldwide network from Mexico. Purely Mexican-owned auto parts producers have also succeeded in becoming strategic partners in these networks, notably of Ford.

Mercedes Benz, since the 1980s a minority partner in a Mexican truck producer, also reacted to the reforms and made Mexico a part of its North American strategy. It acquired control of its partner, and in 1992-93 invested \$300 million in modernizing and expanding its facilities including the addition of a passenger car production line.

The same transformation took place with Xerox and IBM, which before the liberalization were among the few foreign invested facilities in Mexico with a significant presence in international trade, and which since the liberalization have, along with many new entrants to this kind of activity, dramatically increased the world-wide integration of their Mexican subsidiaries.

FDI flows into Mexico started to increase again as investors anticipated the effects of NAFTA and continuing liberalization in Mexico. In 1991 the amount exceeded \$4 billion for the first time, and has continued to rise since then. Much of this increase was in globalizing FDI, in response to the trade liberalization and the expectation of a successful NAFTA negotiation, but the expectation of growth in the Mexican market was also an important driving factor.

There were still important *de facto* obstacles to globalizing FDI coming to Mexico during the early 1990s. For greenfield investments (new, wholly-owned factories) the reforms were sufficient. But mergers, acquisitions, and joint ventures were still impeded by a combination of remaining legal restrictions in some key sectors and by informal mechanisms. Despite the change in regulatory practice in 1989, the reluctance of domestic investors to give up operational control to foreigners was partly an inheritance of past policies and practices. In addition, large Mexican conglomerates were strong, cash rich, had long experience with local markets, and were the beneficiaries of privatizations and close relations with the government. These factors kept the level of FDI below \$5 billion per year, even though there was great expectation of successful NAFTA negotiations.

In 1993, with NAFTA approval in the near future and a more favorable political climate, the government codified both the regulations of 1989 and the coming NAFTA rules on FDI in a new FDI

Manufacturing is not the only part of the economy in which world-class production is important. Telecommunications service is crucial to provide an environment in which companies can achieve world-competitive costs, quality and time of delivery. Southwestern Bell Corp (SBC) of the USA wanted to invest in Mexico but was legally unable to own control in a local telephone company, even under the 1989 law. SBC nevertheless took a minority position in Telmex, the formerly government-owned and operated telecom monopoly that was being privatized, in 1990. SBC provide technology and finance to the newly privatized firm with an investment of \$1 billion. This investment is an integral part of SBC's international operation and plans, which include France, South Africa, Switzerland and Brazil. Its recent acquisition of Ameritech indicates further impetus in the globalizing FDI, as Ameritech holds large international operations. There is little doubt that SBC would further expand its involvement in Mexico as communications between Mexico and the US expand, especially if remaining restrictions on local telephones are removed. Similarly, the opening of the banking system to FDI in 1995, encouraged Citibank to be the first US bank to acquire a Mexican commercial bank, Confia. This acquisition, in the context of subsequent additional liberalizations of banking regulations, will enable Citibank to expand its deposit base and to provide a full range of world-class services to all clients in Mexico. Operations of Citibank and Confia are now part of the global system of credit management of Citibank.

law. The old 1973 law was repealed. This new law made few *de facto* changes in the liberal climate that had prevailed since 1989, but by putting the new rules and practices in a law, rather than in regulations which could be more easily changed, reduced still further any uncertainty that investors might have about the future of the reforms.

Ironically, at the end of the same year that NAFTA was approved, 1994, risky monetary and credit policies by the outgoing Administration in Mexico precipitated another foreign debt crisis. One of the few good effects of this painful crisis was to accentuate the attractiveness of Mexico for globalizing FDI and to remove or reduce many of

the most important remaining obstacles. The peso devaluation improved export profitability, while many producers of industrial materials wanted to be linked to a global network as a precondition to continue in operation. In non-tradables, however, profits fell and some foreign investors who had entered Mexico recently and who depended completely on Mexican consumer demand, pulled out. This was the case of retailers JC Penny and K-Mart, or franchises like Twinings.

In 1995 and 1996 the Government liberalized FDI in natural gas distribution and the banking sector, even though these had remained restricted even after NAFTA. Foreign investors responded quickly. All of the recent regional gas distribution concessions to private enterprise include foreign parties in partnership with a local business, such as Repsol of Spain, Gas de France and Novo Industries of California. Gas deregulation gave additional impetus to the earlier liberalization in electricity generation, as the new generators will use gas as a fuel. In electricity both GE and Mitsubishi participated in the first two private generation projects, approved in 1996 and 1997.

The share of M&A increased sharply as many local firms faced losses from the peso devaluation and were unable to maintain operations without a link to foreign markets and global networks. At the same time, the government removed many of the remaining sectoral restrictions on foreign ownership, importantly in banking, gas, and electricity generation. Foreign investors came to control some of the firms in which they had entered initially with a minority stake, such as the retailer Cifra (now controlled by WalMart), Iusacell (a cellular telephone firm now controlled by Bell Atlantic) and many banks.

Much globalizing FDI went into *maquiladoras*, which left behind the simple assembly focus of their beginnings decades earlier and came to include quite a few complex, medium- or even high-tech manufacturing processes. It is estimated that 90% of *maquila* investment during the last few years is of the globalizing type. Although many existing plants still have a limited focus on assembling from largely foreign components, even they are gradually comprising more complex processes. One example is the large Delphi plants owned by GM, employing many Mexican engineers in product design. The standards of operation, quality, and efficiency of these plants are of the same or higher levels than those of their sister plants in North America. Other examples include AT&T, GM, Emerson Electric and Sony. This change towards sophisticated, integrated manufacturing anticipates the *de facto* end of the *maquiladora* status, as under NAFTA any exporter from Mexico to the US or Canada will benefit from the same privileges as do the *maquiladoras*, after a seven-year phase-out period that ends in 2001.

Large acquisitions, an intensification of globalizing manufacturing activity, and more deregulation thus explain the jump in FDI inflows from 1994 onwards. Most of this FDI was of the globalizing type.

Summary. A summary view of the policy changes described here, and the results in terms of FDI flows to Mexico, is presented in the Table 1. The story in its simplest form is that Mexico executed a series of reforms in three areas of policy, over a period of about 14 years (from 1982 to 1996):

- Monetary, fiscal, and exchange rate reforms, to stabilize the economy, began in 1982.
- Trade reforms, which liberalized imports (licensing was abolished and tariffs lowered) followed around 1985.
- Removal of restrictions on FDI began in 1989, with the freeing of more and more sectors from restrictions on the percentage of foreign ownership, abolition of TRIMS (notably, domestic content requirements), and the privatizations of former government monopolies and the opening of those sectors to FDI. NAFTA, negotiated during the early '90s and implemented in 1994, increased and locked in all those reforms in both trade and foreign investment rules. Other regulations which restricted the freedom of foreign-invested firms to change their operations were also abolished or relaxed. Additional sectors were liberalized in 1995 and 1996.

The results have included a remarkable increase in the quantity of FDI inflows, rising from the levels around \$2 billion per year in the late 1980s, to around \$4 billion during the early 1990s and averaging \$10 billion per year since 1994. But even these dramatic increases in amounts are perhaps less important than the changes in quality, as most of the additional FDI during the last five years has created world-class facilities that are competitive in price and quality with others all over the world, and that therefore can, and do, include Mexico as parts of the global strategies of multinational corporations. The days of high-cost, old technology factories producing for Mexican consumers only are gone, as are the days of manufactured exports consisting mostly of simple, low-value-added products based on cheap Mexican labor. Mexico today is more and more integrated in world-class production linkages, and this includes not only foreign-invested companies but also a growing number of purely Mexican firms that have also taken advantage of the changed policy framework.

Table 1
Foreign Direct Investment in Mexico and Policy Changes: 1989-97
(\$ bn or percentages)

	\$ FDI Inflow s	Approximate Shares (%)		Approximate Shares (%)		Estimated Shares (%) of globalizing FDI	Policy Changes
		M&A	Greenfiel d	Tradable s	Non- Tradable s		
1989	3.0	10	90	40	60	30	New FDI regulations – elimination of 51% Mexican majority in most sectors
1990	2.6	10	90	40	60	40	Privatization of telephones, mining, steel, tourism, airlines
1991	4.8	20	80	40	60	50	NAFTA negotiations begin
1992	4.4	20	80	40	60	60	Privatization of banks, financial system reforms
1993	4.4	30	70	40	60	60	Imminent NAFTA approval, new FDI law codifying the 1989 regulations, more privatizations
1994	11.0	30	70	40	60	70	NAFTA approval, relaxed FDI restrictions
1995	9.5	50	50	80	20	80	Economic crisis; deregulation in gas, electricity
1996	7.6	50	50	85	15	90	Banking system opening to FDI
1997	12.1	60	40	85	15	90	Long distance telephone, communications deregulation

Source: Bank of Mexico on FDI flows and FIAS' estimates on shares.

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Competition, Corporate Governance, and Regulation in Central Asia

Uzbekistan's Structural Reform Challenges

Harry G. Broadman

Like many Central Asian republics, Uzbekistan has adopted a gradual, cautious approach in its transition to a market economy. It has had some success attaining macroeconomic stability, but microeconomic reforms have lagged behind. It is time to accelerate structural reform.



Summary findings

In Uzbekistan state enterprises are being changed into shareholding companies, and private enterprises account for 45 percent of all registered firms. But business decisions to set prices, output, and investment are often not market-based, nor wholly within the purview of businesses, especially those in commercial manufacturing and services.

Lines of authority for corporate governance — from state enterprises to private enterprises — are ill-defined, so there is little discipline on corporate performance and little separation between government and business.

Nascent frameworks have been created for competition policy (for firms in the commercial sector) and regulatory policy (governing utilities in the infrastructure monopoly sector). But implementation and enforcement have been hampered by old-style instruments (such as price controls) rooted in central planning, by lack of a strong independent regulatory rule-making authority, by the limited understanding of the basic concepts of competition and regulatory reform, and by weak institutional capabilities for analyzing market structure and business performance.

Based on fieldwork in Uzbekistan, Broadman recommends:

- Deepening senior policy officials' understanding of, and appreciation of the benefits from, enterprise competition and how it affects economic growth.

- Reforming competition policy institutions and legal frameworks in line with the country's goal of strengthening structural reforms and improving macroeconomic policy.

- Improving the ability of government and associated institutions to assess Uzbekistan's industrial market structure and the determinants of enterprise conduct and performance.

- Making the authority responsible for competition and regulatory policymaking into an independent agency — a "champion" of competition — answerable directly to the prime minister.

- Strengthening incentives and institutions for corporate governance and bringing them in line with international practice.

- Subjecting infrastructure monopolies to systemic competitive restructuring and unbundling, where appropriate. For other utilities, depoliticize tariff setting and implementation of regulations; ensure that price, output, and investment decisions by service suppliers are procompetitive (creating a level playing field among users); and increase transparency and accountability to the public.

This paper — a product of the Poverty Reduction and Economic Management Sector Unit, Europe and Central Asia Regional Office — is part of a larger effort in the region to assess structural reform in Central Asia. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Sandra Craig, room H4-166, telephone 202-473-3160, fax 202-522-2753, email address scraig@worldbank.org. Policy Research Working Papers are also posted on the Web at www.worldbank.org/research/workingpapers. The author may be contacted at hbroadman@worldbank.org. May 2000. (21 pages)

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Competition, Corporate Governance and Regulation in Central Asia: Uzbekistan's Structural Reform Challenges

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I. INTRODUCTION

Like most Central Asian republics, Uzbekistan has adopted a gradual and cautious approach in its transition to a market economy.¹ Although some measure of success has been achieved in attaining short-term macroeconomic stability,² microeconomic reforms have lagged behind. The policy agenda for structural reform remains formidable.

An active transformation of Uzbek state-owned enterprises (SOEs) into shareholding companies has been underway and private enterprises account for 45 percent of the total number of registered firms (where the vast majority of private firms are of small and medium scale). But business decisions to set prices, output and investment are often not market-based, nor wholly within the purview of businesses, especially those operating in the commercial manufacturing and services sectors, and this creates market distortions and misallocation of resources. Lines of authority for corporate governance are ill-defined, not only in SOEs and State "trade associations", but also in privatized firms, engendering weak external and internal disciplines on corporate performance, and little effective separation between government and business. While nascent legal frameworks for both competition policy, governing firms in the commercial sector, and regulatory policy, governing firms in the infrastructure ("utility") monopoly sector, have been created, implementation and enforcement have been hampered by the use of old-style instruments rooted in central planning (e.g., uniform market share monopoly registration, price controls, etc.), the lack of a strong independent regulatory rule-making authority, poor understanding of competition and regulatory reform concepts, and weak institutional capabilities for analysis of market structure and business performance.

The experience from other transition countries demonstrates that successfully dealing with these problems are critical for laying the structural basis for robust and enduring growth. Uzbekistan's government is cognizant of these challenges and recognizes that without effectively addressing them, there are pronounced risks that the overall economic reform program could be undermined. Indeed, one of the key items on the government's policy agenda, as part of its comprehensive program of economic reforms for the period 2000-2005, as outlined in the Cabinet of Ministers Resolution No. 296 of June 10, 1999, is to develop new structural reforms that improve Uzbekistan's competitive business environment.³

This paper—based on fieldwork in Uzbekistan—outlines recommendations for developing such a structural reform program. Six main policy challenges are identified, and the paper is organized according to those challenges: (i) concepts of competition and regulation in a market economy appear to be not well understood both by policy-makers and market participants; (ii) the formulation and implementation of competition and regulatory policies are poorly linked to the core objectives and design of the Government's overall economic reform program; (iii) the Government has developed a limited knowledge base and capacity for analysis of the country's industrial structure and determinants of a more competitive business environment; (iv) the organizational and functional independence of the Government's authority for formulating and enforcing competition and regulatory policies, as well as the system for effective checks and balances to ensure strong public transparency and accountability, are weak; (v) corporate governance incentives to instill strong competitive discipline on firms' performance and to engender effective separation between government and business, especially in state owned "associations" and related holding groups are blunted; and (vi) there is substantial scope both for competitive restructuring and unbundling of infrastructure monopolies, especially those that are not "naturally" monopolistic, and for reform of regulatory oversight of infrastructure monopoly enterprises to a strong rules-based regime.

¹ See Karimov (1998).

² See Zettelmeyer (1998).

³ For a description of the overall reform program see World Bank (1999).

Because many of the structural problems found in Uzbekistan are common with those in other Central Asian republics, the analysis presented and the policy recommendations developed in this paper are applicable beyond Uzbekistan *per se*.

II. UNDERSTANDING OF CONCEPTS OF COMPETITION AND REGULATION

Institutional Framework. Uzbekistan has made substantial progress since the advent of reform to develop an institutional framework to foster the establishment of a competitive business environment. While the framework is still evolving, to date it includes, among other measures and actions, the establishment of the Anti-Monopoly Committee (AMC), which is housed within the Ministry of Finance; development of program entitled *The Concept of State Anti-Monopoly Policy*, which formulates the main objectives of the Government's competition and regulatory policy; and enactment of several laws, such as the laws "On Competition and Restriction of Monopoly Activity in Commodity Markets", "On the Limitation of Monopolistic Activity", "On Natural Monopolies", "On Protection of Consumers' Rights", and "On Advertising".

As articulated in the *Concept of State Anti-Monopoly Policy*, the central objectives of the Government's competition and regulatory reform program—implemented by the AMC—are to develop competition and entrepreneurship in Uzbekistan's economy; regulate the activities of monopoly enterprises; prevent abuse by firms with dominant market positions; enforce sanctions on firms who engage in unfair competition; and protect consumer rights.

The nascent institutional framework and policy objectives are generally consistent with international practice. In trying to achieve the objectives, however, Uzbekistan's authorities face a key challenge: ensuring that policy officials in all key agencies and ministries (at both the national and local levels) as well as market participants—businesses (including SOEs, the Privatization Investment Funds (PIFs) and banks), consumers, workers, and the general public—both understand the basic concepts of competition and regulation, and are motivated to act in such a way as to capitalize on the role that competitive forces can play in fueling economic prosperity and growth. There are several areas where this challenge is particularly pronounced and where there is a priority for action—in particular mobilizing training, pragmatic policy advice and public education about competition and regulation.

Monopoly Register. One of the primary instruments by which the AMC implements competition policy is through its Register of Monopoly Enterprises – a policy instrument common to Russia and many other CIS countries.⁴ Uzbek enterprises that are deemed as "dominant"—defined by statute as generally having a market share of at least 65 percent, and under certain conditions a market share of at least 35 percent — are listed on AMC's Register and therefore must declare (register) their prices and profits for AMC approval. In addition, registered monopolists, once they agree with their input sellers and output buyers on volumes, delivery times, and other conditions (as well as prices) must register these transaction terms with the AMC along with their expected profits. In certain cases—typically for infrastructure ("utility") monopolies—the AMC directly determines prices and profits.

As of October 1, 1999 there were 716 enterprises and 1,924 products listed in the AMC's Monopoly Register, of which 91 enterprises and 205 products were registered as monopolies at the national (Republic) level, with the remaining (and vast majority) of monopoly firms and products registered in the AMC's 14 regional offices. Table 1 indicates the sectoral distribution of the registered monopolies. In Uzbekistan there are approximately 176,800 firms with business licenses, the vast

⁴ A description of Russia's competition policy framework is contained in Broadman (2000).

majority of which are small and medium scale. Private firms account for about 45 percent of the total number of registered businesses.

Table 1: Uzbekistan Enterprises Registered by the Anti-Monopoly Committee as Monopolies (Republic and Local Levels; as of October 1, 1999)

Sectors	Number of Enterprises	Number of Products
Bakery, grain and flour	18	40
Coal mining	5	6
Natural Gas	4	5
Food	97	551
Light industry	30	62
Local industry	11	22
Petrochemicals	8	33
Machinery	30	63
Construction materials	71	199
Furniture	16	48
Metallurgy	5	9
Services	323	690
Others	80	157
Total	716	1924

Source: Uzbekistan Anti-Monopoly Committee

Price Control vs. Monitoring. Senior management of the AMC recognizes that reliance on price and profit control is neither an efficient or desirable approach to advance competition in the commercial sectors, and that the process is creating misallocation of resources in the economy. Accordingly, as set out in *Major Strategic Measures to Improve the Operations of the AMC*, the Committee has set a goal to switch to a system of monitoring by end-2000. However, neither the AMC nor the business community has adequate capacity to appreciate fully how to make the transition to a system of monitoring and draw lessons from international experience in this regard.

Defining Economic Market Boundaries. More fundamentally, there appears to be poor understanding of and confusion about the basic concepts of competition needed to implement such a system, such as: definition of product and geographic market boundaries (allowing for economically meaningful measures of market share and dominance rather than application of statutorily defined quantitative formulae that artificially classify firms as monopolies); price and cross-elasticities to gauge market demand and product substitutability; marginal and fixed costs and their relationship to price-setting and profit maximization; seller and buyer concentration; determinants of barriers to entry and exit;

etc. The staff of the AMC, with the assistance of international experts, has been undergoing training in competition issues over the past year, and the AMC has recently developed a *Workplan for Training and Assistance* for the future that, if implemented, could help remedy some of these deficiencies.

Strategic Firms. Another key component of the AMC's program is development of plans for the "demonopolization" of certain sectors and enterprises in the Uzbekistan economy. This is a laudable objective: the competitive restructuring of many of Uzbekistan's industries should be a high priority item on the Government's reform agenda. Yet as described in the draft *Program of Formation of a Competitive Environment for 2000-2005*, tabled with the Cabinet of Ministers in late 1999, the proposed mechanisms for such restructuring are at variance with an approach based on economic concepts of competition.

Twenty-nine sectors/firms are identified as candidates for demonopolization, ranging from champagne and cognac production to backpacks and toilet soap to mayonnaise and various oil products. It is dubious that some of the sectors identified would truly qualify as strategically important for the boosting the economy's competitiveness and worth the government expending its limited resources and political capital on restructuring. Moreover, in some cases, the indicated market shares targeted for reduction are unlikely to signal monopoly power; for example, the backpack producer has a 37% market share, and the refinery producing diesel fuel and fuel oil has market shares of 20% in the former and 15% in the latter. Clearly, implementation of demonopolization is a complex endeavor for any government and must be done with great care so as to not engender new distortions in the economy. In this regard, there is a need for further articulation of Uzbekistan's demonopolization strategy and the mechanisms used for its implementation.

Competition Legislation. Improvements of the existing legislative framework for competition and regulatory policy are also needed, and this is recognized by the AMC as a priority area for reform. The Committee has identified, with the assistance of international experts, several areas where amendments or new legislation are needed, including demonopolization in commodity markets, anti-collusion measures, shareholder and property rights protection, rate-setting for regulated utility monopolies, false advertising, and consumer rights protection. In this context, the use of legislative concepts from international experience could be extremely useful in legislative drafting. Equally important, success in passage and implementation of any new legislation in this area will be greatly furthered by a deeper understanding of such concepts by members of the legislature and the affected groups—businesses, workers and consumers. Accordingly outreach and education efforts along these lines should thus be developed.

Public Education and Outreach. More generally, non-governmental organizations (NGOs) could play an important role in public education about the benefits of competition in furthering Uzbekistan's economic development. As in other countries, establishment of independent non-profit "competition education" foundations, which would be perceived by society as non-partisan, could leverage the Government's own public outreach efforts. In some countries, such groups have also taken on an ombudsman role, providing a very effective neutral vehicle for airing consumers' complaints about business violations, corruption and inefficiencies in government programs. Such a process can instill greater "ownership" by the population of market reforms and help motivate their acceptance and behavioral change.

III. LINKING COMPETITION POLICY TO THE STRUCTURAL REFORM PROGRAM

Fostering an improved business environment in Uzbekistan is a core objective of the authorities' economic reform program. Yet to date, competition and regulatory policies and the specific goals they are designed to achieve, have not been fully incorporated within the Government's broader structural and

macroeconomic reform programs; nor at the same time have the development and implementation of these other reform objectives been adequately informed by the market-oriented goals of enhancing competitive forces.

Removing Barriers to New Entrants and Restructuring Incumbents. In general, the emphasis of the existing competition policy regime has focused on dealing with the regulation of incumbent firms. But as part of the broader objectives of encouraging structural reform and the transition to a market system, a greater orientation is needed towards generating growth through the formation of new enterprises, not just via privatization of existing SOEs, but more importantly, through “greenfield” entry of new start-ups—both domestic investors and foreign investors. The experience of many other transition economies suggests that new entrants, particularly small and medium enterprises (SMEs), are the engines of growth and job creation. In Uzbekistan, recent surveys suggest that potential new businesses face substantial administrative and policy barriers to entry, including elaborate licensing requirements at both the national and local levels; impeded access to foreign exchange; difficulty in arranging for financing from banks or other sources; arbitrary and burdensome taxation; difficulties in arranging for product distribution, among others.⁵ Focusing on developing solutions to these problems as part of the broader structural reform agenda is critical to boosting competition.

Exit of Nonviable Firms and Hardening Budget Constraints. By the same token, relatively little policy emphasis has been directed toward facilitating bankruptcy, including where necessary, liquidation, of insolvent firms in Uzbekistan. The concerns about the potential social costs of such actions is understandable. Yet, with adequate social safety nets in place, such costs can be substantially reduced. International experience can provide to the Uzbekistan authorities important lessons about the benefits of reducing fiscal and financial subsidies to firms—“hardening budget constraints”—to engender improved corporate competitiveness from viable firms and to expose those that are no longer commercially viable. Indeed, viewed from the broader structural reform perspective, the bankruptcy process engenders important benefits: it provides for the re-channeling of productive assets bottled up in inefficient firms to new ventures where employment can be expanded and new products created. Importantly, facilitating the bankruptcy process should not be seen as simply in the purview of the government; indeed, on the contrary, the main focus should be on strengthening the legal rights of creditors in Uzbekistan. In turn this means accelerating reform of the country’s banking system to one where banks’ credit, lending and debt collection decisions are scrupulously made on the basis of commercial and risk criteria. Exacting such external discipline on the performance of firms in the real sector will go along way to fostering the competitive restructuring of Uzbekistan’s industry.

Openness to International Trade and Liberalization of Foreign Exchange. Trade and foreign exchange restrictions in Uzbekistan are pronounced. They serve to shelter noncompetitive industries from market forces and as a result encourage misallocation of resources, lost output and poor product/service quality. Restrictive trade practices, such as registration and prepayment requirements for imports and high average import tariffs, were enacted in 1997 and remain in place. State trading monopolies for cotton and gold exports, which generate approximately 40% of the country’s foreign exchange earnings, also undermine competition within the economy. At the same time, the dual exchange rate system and foreign exchange surrender requirements engender gross structural distortions in the economy. Removal of the trade and foreign exchange restrictions is widely seen as a precondition for enhancing the competitiveness of the economy and for putting Uzbekistan on a path for enduring growth. Indeed, although liberalization of the foreign exchange regime is often seen as a macroeconomic policy objective, its impacts on advancing the competitive structure of the economy are as critical. Equally important, accession to the WTO provides an important vehicle to reform the country’s trade regime and to lock-in, under international commitments, the removal of existing trade restrictions;

⁵ LaFleur (1999); AMCHAM Uzbekistan (1999).

through the prism of identifying potent reforms to instill competition within the Uzbekistan economy, WTO accession should be a clear priority for the Government.

Improving the Policy Regime for Foreign Direct Investment. Improving the legal and regulatory regime governing foreign direct investment (FDI) inflows to Uzbekistan should be seen as another important policy component of the broader structural reform program to enhance competition within the country's industrial base. FDI inflows not only mean the transfer of financial resources, but more importantly usually mean the economy is host to the transfer of advances in technology, the introduction of new products and production processes, enhancements in managerial and technical skills, and competitive pressure on domestic firms to perform more efficiently. Bringing Uzbekistan's FDI policy regime in line with international best practice would entail, among other measures that would facilitate new entry: providing for non-discriminatory, "national treatment" to foreign investors; phasing out existing trade-related investment measures (e.g., local content restrictions, export performance requirements and restrictions on use of foreign exchange); freedom for investment-related transfers (e.g., profits, royalties); binding international arbitration for investor-State disputes; and international law standards for expropriation.⁶

Industrial Policy. There is also the need for the design of country's industrial policy program to be better informed by—indeed be reconciled with—the Government's emerging competition policy objectives. While the latter is to give emphasis to greater use of market forces in the economy, the industrial policy program still bears a heavy administrative imprint and market control. To illustrate the problem, Box 1 shows how the draft *Program of Formation of a Competitive Environment for 2000-2005* formulates the plan for the competitive restructuring (or demonopolization) of the cognac sector. The plan is striking for its detail as to the seemingly engineered changes in production and market shares for the various producers in the sector. It casts strong doubt about any significant role envisioned by its drafters that market forces will play in the sector's future structure.

Box 1: Restructuring Plan for Joint Stock Company (JSC) "Khovrenko": Cognac Producer

The current (1999) market share of JSC "Khovrenko" is 41.3%. The plan is to reduce the share of the "monopolist" on domestic market down to 24-26% by the year 2005 by increasing the market shares of:

- JSC "Yangiyul" - from 18% in the year 2000 up to 20-22% in the year 2005;
- JSC "Shakhrud" - from 20% in 2000 up to 22-24% in 2005;
- JV "Bulungur" – from 13% in 2000 up to 15-18% in 2005;
- JSC "Urgench Sharobi" – from 7% in 2000 up to 8-9% in 2005.
- Increase exports of JSC "Khovrenko" from 25% in 2000 up to 30% in 2005.
- In the year 2005 JSC "Khovrenko" will be excluded from the State Registry of Monopolists since its market share will be reduced.

Source: Annex II, *Program of Formation of a Competitive Environment for 2000-2005*, Government of Uzbekistan; draft of October 1999.

⁶ See Bergsman, Broadman and Drebenstov (1999).

IV. ENHANCING ANALYTICAL CAPABILITIES

Effective economic policy formulation and implementation must be start with high quality and up-to-date economic information and analysis. Without a sound knowledge base about an economy's market structure and the determinants of firms' behavior, it is virtually impossible to design competition and regulatory policies that will have their intended impacts; in fact under such circumstances it is quite possible that best intentioned reforms could well create deleterious outcomes and worsen existing problems. Moreover, without such information, policy formulation in other economic spheres—for example, in the area of macroeconomic reform, such as gauging the price and market impacts of foreign exchange liberalization—will be made more difficult and subject to errors.

Need for More Empirical Assessments of Competition. Although improvements are underway—in particular within the Center for Economic Research, a quasi-Government think-tank partly funded by UNDP and TACIS—the existing database on the structure of Uzbekistan's industry is still rudimentary. While numerous analyses of particular commodity markets have been undertaken (as part of the monopoly registry process) relatively few major empirical studies of the systemic determinants of market power within key bottleneck sectors of the economy have been carried out.

Cross-Sectoral Analysis. In addition, cross-sectoral analyses that assess structural and behavioral linkages across industries and markets do not appear to have been undertaken: for example, how price distortions, production inefficiencies and bottlenecks in the infrastructure monopoly sectors, such as electric power, affect business performance by electric power consuming firms in the tradables sector, such as cotton ginning. Similarly there has been limited analysis of the competitive impacts of existing horizontal and vertical integration, and the extent to which current horizontal and vertical structures, especially in the 56 “associations” and holding group structures, engender economies of scale and scope. Without this integrative, economy-wide perspective, the formulation of competition and regulatory policies on a “general equilibrium” basis is very difficult and instead forces policy-makers to base decisions on only a partial view of the determinants of industrial performance in the economy.

Statutory vs. Economic Definitions of Markets. It also appears that the taxonomy of data that are collected and analyzed is determined more by statutory than economic criteria. For example, the data are usually assessed according to the 65%/35% legal classification of monopolies. Rather what is needed is analysis of data to determine the economic boundaries of markets (and thus firms' market shares), based on questions of product substitutability and geographic limits of total delivered product costs relative to demand.

Influence of Market Structure on Corporate Performance. Equally important, there is a lack of analysis of how conventional elements of industrial structure, such as seller concentration, barriers to entry, ownership structure, among other factors, influence the competitive conduct of firms. In this regard it would be important to know on a cross-sectional basis as well as over time, what gives rise to variations among Uzbekistan's firms in terms of price-cost margins and rates of return; product innovation and introduction of new processes; product and service quality; access to and disposition of domestic financing and earnings; incidence of foreign exchange; and export performance.

The AMC and the Center for Economic Research recognize the deficiencies in the existing knowledge base and analytical capabilities. Accordingly they have begun to develop action plans to remedy the situation. Indeed the Center for Economic Research is currently establishing a new thematic team within the organization that will focus exclusively on analysis of competition in the economy. Clearly, the knowledge-building agenda before the AMC and the Center is big, and it will take time to implement. Against the backdrop of limited human and financial resources to undertake this effort, it is important that as the action plans are further refined priorities be set. The set of issues identified above

suggests areas for priority attention. Yet even within those areas, data collection and analysis should be tailored first toward apparent “worst offenders” and where large amounts of resources in the economy are potentially at stake.

V. CREATING A COMPETITION “CHAMPION” WITHIN GOVERNMENT

The current Anti-Monopoly Committee, which was established by Presidential Decree in May 1996, is an outgrowth from the earlier Committee on Prices, which played a central role under the planned economic system. This in part explains the AMC’s reliance on price controls as a competition policy instrument. Although, as noted above, the AMC has set itself the objective of moving to a monitoring type of system in the near future, the perception by marketplace participants of the organization’s functions as a price (and other transaction terms) control agency will continue to be subject to inertia from the past.

Organizational Conflicts of Interest. This problem is compounded by the fact that the Anti-Monopoly Committee is actually part of the Ministry of Finance, with a Deputy Finance Minister serving as the AMC chairman. Housing the organization within the Finance Ministry is, again, an outgrowth of the AMC’s earlier incarnation as the Committee on Prices. Other transition economies’ competition agencies have had similar early organizational structures. But effective formulation and enforcement of competition and regulatory policies requires an agency with a cross-cutting, “honest broker” mandate. It also must be seen by all market participants—businesses, workers, consumers and the general public—as pursuing a credible non-partisan agenda. In part this means operating independent of line agencies, including the Finance Ministry, which, by definition will have an interest in increasing revenues and thus may create an appearance of a conflict of interest if it has jurisdiction over competition and regulatory policy. For the same conflict-of-interest reasons, it also means operating the competition agency independently of sectoral agencies. Indeed international experience suggests that effective competition agencies are those that operate in a de-politicized fashion and have the clout—the “teeth”—to deal with powerful vested interests, not only in the economy, but equally important on an inter-agency basis in cabinet debates.

Lack of Institutional Resources. The organizational structure of the AMC is comprised of a Republic level headquarters office in Tashkent and 14 local level branch offices located in various regions of the country. The total number of AMC staff is 414 persons, of which 55 work at the national level; in other words the vast majority of AMC officials work in the Committee’s branch offices at the local level. The large allotment of staff in the regions reflects the emphasis of the AMC’s activities at the local level. For example, in addition to its monopoly registering and price/profit control functions (described earlier), the AMC is involved in the promotion of competition in selective sectors carried out by the regional offices in concert with local governments. This includes, for example, establishing mechanisms to help ensure that public procurements at the local level are mediated through open and competitive tenders. The AMC is also involved at the local level in the promotion of specific investment projects in certain sectors or geographic areas of the country; for example, fostering banks to make credit available to SMEs.

Local Level Focus and Regulatory Capture. To be sure, the focus on strengthening competition at the local level is key, since that is where most business transactions are carried out. But by the same token, in Uzbekistan, as in other transition economies with nascent economic institutions, that is where the problem of “regulatory capture” is often most pronounced and prevalent: local authorities and business interests are often co-mingled and there are weak systems for checks and balances. However, it appears that AMC practices and interpretation of statutes and regulations is not consistent across regions and local markets. Discretion in enforcement appears to be exercised. This of course only serves to exacerbate the capture problem. Moreover, the role AMC branch offices play in promoting projects at the

local level, especially involvement in fostering bank credit lines, makes the agency vulnerable to regulatory capture, to say nothing of the fact that such activities undermine the Government's collateral objective of creating a market-oriented banking sector. Of course, local government officials themselves may be in violation of competition statutes—e.g., protecting local businesses from entry through delaying issuance of new licenses; provision of fiscal subsidies to incumbent firms; creating an nonlevel playing field regarding energy prices charged by local utilities to newcomers, etc.—and the AMC has brought charges in such cases. But without a strong, independent AMC, it will be difficult to enforce the law effectively at the local level, where the stakes are perhaps highest.

Need for an Independent Competition Policy Authority. There is a clear need to break from the past and reinvigorate the AMC as an agency independent from the Ministry of Finance, with a new mandate and “corporate culture”. There is not a single “best” model that the restructured agency should aim for. Different countries use different organizational set ups. Among other schemes, some have established a unitary independent agency that combines all competition and regulatory policy functions; some have established both an independent competition policy agency as well as an independent regulatory agency (or agencies); and some have established portions of competition policy functions within a ministry of justice as well as other portions in an independent agency; etc. But international practice does suggest a set of principles upon which a revitalized competition agency should operate. Such principles would likely include the following elements: (i) competition policy/regulatory decisions should be rules-based, judgements made in an impartial, independent fashion, and remedies devised on the merits of the case, in line with competition policy objectives; (ii) the entity's budget should be financially autonomous from other ministries; (iii) the entity head should have clear lines of authority and appointed and dismissed by only the Prime Minister, subject to strict, well-defined criteria, and/or serve for a fixed term; (iv) there should be a transparent appeals process for consumers and businesses, including public hearings; (v) the agency should have autonomous legislative authority; (vi) the agency's performance should be subject to regular public monitoring to ensure the public interest is protected; (vii) regional offices should be sufficient in number and breadth to ensure effective oversight and implementation at sub-republic level; and (viii) the agency should be staffed with adequate number of professionals with the requisite skills and technical expertise.

Clearly, reorganizing the AMC is a complex endeavor and will take time. The task should be undertaken as a deliberative process with public discussion, especially involving the major affected parties within the country. The advice of practitioners from other countries should be sought so as to learn the lessons of international experience. Nonetheless, a structure should be established that best suits Uzbekistan's own characteristics and challenges.

VI. STRENGTHENING CORPORATE GOVERNANCE INCENTIVES

A critical component for the improvement of the business environment is the institution of market-oriented incentives for corporate governance practices. In Uzbekistan sound corporate governance practices are blunted because of ill-defined corporate organizational structures and institutions, contradictory lines of authority, and weak disciplines/checks and balances, especially in the management of State assets. Although Uzbekistan has enacted a Company Law, in practice the structure of the modern corporation has not yet been widely adopted in the country. Uzbekistan's approach to corporate governance—particularly in the key firms, which still have heavily state involvement—shares many similarities with China, Russia and other transition economies.⁷

⁷ China's state asset management approach to corporate governance is described in Broadman (1999) and World Bank (1997); Russia's post-privatization corporate governance challenges are described in Broadman (1999).

The Modern Corporate Form. Generically, there are four key attributes of the modern corporate form worldwide; see Box 2. They enable the enterprise to mobilize and deploy financial and human capital and transform inputs into outputs on a large scale efficiently. The weakness or absence of one or more of the attributes significantly impairs the corporation's efficiency. For example, with limited transferability of ownership interests, the flexibility of owners to reallocate assets to higher-use values is blunted. This would distort the market value of the business, which indicates how well management is performing. Thus, weak transferability would undercut a powerful mechanism that disciplines corporate management to satisfy owners' goals of asset value maintenance and increase.

Operating a large modern corporation inevitably involves the separation of the firm's ownership from its management. The owners select managers to run the firm, and in the process the owners relinquish some of their control as they delegate (some) decision-making to managers. "Corporate governance" refers to the set of relationships that link the ownership and control of an enterprise, the mechanisms through which these relationships are mediated (e.g., monitoring and evaluation controls), and the nature of incentives, risks and constraints that affect how the actions of a firm's owners, managers and workers as well as others (e.g., banks, suppliers and customers) influence the firm's conduct and performance.⁸ The classic problem of the owners is how to structure *internally* the corporate organization and its operations in a manner that provides the proper incentives to managers for the attainment of the owners' goals. At the same time, various *external* incentives discipline the conduct of managers and thus ultimately affect firm performance (see Box 3). International experience suggests that improved business performance depends not only on how well a business implements the four key attributes that comprise the modern corporate form, but also on the dynamic interplay of these internal and external incentives.

Box 2: The Four Structural Attributes of the Modern Corporation

1. **Separate identity.** The corporation is a legal entity distinct from its owners ("shareholders"), with a clear definition of and accounting for its own assets and liabilities;
2. **Limited liability for owners.** Owners' risk of financial loss is limited to their contribution to the corporation's capital;
3. **Centralized role for corporate management and a board of directors.** The day-to-day affairs of the corporation are conducted by one or more persons ("managers"), who are hired by the owners. A board of directors, elected by the owners, represents the owners' interests by giving direction to management and carrying out oversight of managers' performance; and
4. **Transferability of ownership shares.** The shareholders' ownership interests are transferable, and a transfer by an owner does not, in itself, change the rights and obligations of the corporation with respect to its own assets and liabilities.

Source: Broadman (1996)

Principal-Agent Problems. Providing for sound corporate governance is a challenge all modern corporations the world over must meet. It is difficult to ensure that the actions of a firm's managers (the "agents") are consistent with the interests of the firm's owners (the "principals"). When managers do not act in the interest of owners, "principal-agent problems" arise. The extent of this conflict depends on a number of factors, most importantly the extent and quality of information about the activities of the managers. Owners have dealt with the principal-agent problem through a variety of means including: increasing the flow of information made available by managers about their activities; more intense monitoring by owners and others (including banks) of managers' conduct and performance; and

⁸ See Shleifer and Vishny (1997).

implementing mechanisms to better align the interests of managers and owners/shareholders (for example performance contracts, stock options and ownership). Of course, different types of corporate governance systems have been used to solve the principal-agent problem. For example, the United States and the United Kingdom rely heavily on shareholders' actions in stock markets, Japan utilizes a bank-based system and Germany's framework is centered on institutional investors.⁹ There is no obvious ranking as to which of these three, or any other, corporate governance system is best for promoting efficient corporations. But there is a clear consensus worldwide that all of the most successful corporate governance systems are centered on the judicious use of market-based incentives. The OECD has recently devised a set of corporate governance principles that provide a useful guideline.¹⁰

Box 3: Internal and External Incentives Determine Corporate Performance

There are two categories of factors whose dynamic interplay determine the performance of the modern corporation: the "internal" incentive arrangements between owners and managers, and the "external" factors that discipline and monitor the behavior of managers and ultimately the firm's performance. While internal incentives are *necessary* to achieve corporate efficiency, they are *not sufficient*; external incentives must also be manifest.

- (a) **Internal Incentives.** These include the structures and mechanisms by which the owners cause the managers to act for the goals set by the former, i.e., the internal "corporate governance" arrangements. This involves defining how the owners, the board of directors and managers interact with one another to fulfill the owners' objectives. The arrangements stipulate how various decisions will be made and who will be accountable for them. The principal decisions include owners' election of the board of directors, the naming of corporate officers, approval/disapproval of changes to the corporate charter, mergers/ acquisitions, increases and decreases in capital, major debt borrowings, disposal of assets, determination and deployment of retained earnings and dividends, and the setting of managerial pay.
- (b) **External Incentives:** These are factors that are not usually under the direct control of owners (although they can have some indirect influence on them). They include the extent of product market competition (including the ability for the firm to affect market prices and for new competitors to enter and exit the market); the functioning of equity and debt markets (including the effectiveness of the "market for corporate control" and of threats of bankruptcy or liquidation for value-subtracting firms); the corporation's legal obligations, including monitoring of financial accounts through independent audits; and the competitiveness of the labor market (including the market for managerial and entrepreneurial talent).

Source: Broadman (1996).

Associations. In Uzbekistan, as epitomized in the case of the 56 "trade associations"—which dominate key sectors—corporate governance practices are, in general, not fully based on market incentives. It appears there is often little distinction between the role of government as policy maker and regulator, on the one hand, and business shareholder (owner) and manager, on the other. Formerly sector ministries, associations were established in 1992-3 by Presidential Decrees, and have charters approved by the Cabinet of Ministers; typically they are not registered as companies under the Company Law. Although the functions of associations vary from sector to sector, they include lobbying to advance "members'" interests; rationalizing output, pricing, investment, distribution, input, and foreign exchange allocation decisions; and operating akin to holding companies. For three case studies of associations, see Box 4. Figure 1 provides an organizational chart of Uzbekneftegaz, the oil and gas association.

⁹ See Aoki and Kim (1995).

¹⁰ OECD (1999).

Box 4: State "Associations" in Uzbekistan

There are 56 "trade associations" in Uzbekistan. Due to consolidation, the number of associations is decreasing; last year three construction associations were terminated. The following summarizes case studies of 3 associations.

Uzavtotrans (motor transport services): Uzavtotrans was created by Presidential decree in 1993, and was formerly a sector ministry; although it officially bears the name of a "joint stock company", it is not registered under the Company Law. Uzavtotrans is essentially an administrative holding group overseeing 285 firms, of which about 215 are either state owned or joint state-private and 70 are wholly private, including one joint-venture; the number of firms with private shareholding has been increasing, virtually all in the freight area. Uzavtotrans describes its role as serving as "an intermediary between the Government and its member-firms". The firms in the association have approximately 80,000 employees. Uzavtotrans has a 60% market share in passenger transport, and a 25% market share in freight transport. The head of Uzavtotrans has the rank of Minister and he is a member of the Cabinet of Ministers. He is elected by the association's "corporation council"—its board of which he is chairman—and his appointment is approved by the President of Uzbekistan. The corporation council has 121 members, of which "40 are major shareholders." Uzavtotrans does not issue a public annual report; the "minister" reports regularly on the sector's plans and performance to the Cabinet. Firms that are members of Uzavtotrans officially pay a membership fee of 1.5% of their reported profits. The association's budget for 1998 was 380 million Som (US\$ 2.75 million). Uzavtotrans does not directly get involved in foreign exchange transactions with its members. However, Uzavtotrans does directly assist their firms in arranging for bank credits: in fact it arranges for State guarantees for the loans and underwrites the credit risk.

Uzbekneftegaz (petroleum and gas): Uzbekneftegaz is a part of the former ministry for oil and gas, which dates back to the break up of the USSR. Created by a 1992 Presidential decree, it has gone through several re-organizations in the past seven years; Uzbekneftegaz is not registered under the Company Law. Its underlying holdings include 8 directly held entities and 79 indirectly held entities. All entities except for one are reported to be joint-stock companies, with at least 51% state ownership, as exercised through Uzbekneftegaz on the underlying entities' boards; the exception is Uzmil Oil, which is a joint venture between Uzbekistan and Malaysia. In total, the firms employ 83,000 persons. In the upper level holding entity itself, there are 127 employees, and its budget for 1999 is 700 million Som (US\$ 5.1 million); no information was available on the fees collected from its members. Uzbekneftegaz is governed by (i) a supervisory committee, which is chaired by the Prime Minister and includes other ministers, other state representatives, including banks; and (ii) a board of directors, which is comprised of nine senior managers of Uzbekneftegaz. The board reports to the supervisory committee. The head of Uzbekneftegaz has the rank of minister and is a member of the Cabinet of Ministers. Uzbekneftegaz does not issue a public annual report; although the CEO does report quarterly to the Cabinet of Ministers on the association's plans and performance. Uzbekneftegaz oversees and "controls" the production, sales and distribution of the products and services of its underlying entities. For domestic sales that Uzbekneftegaz makes to the Ministry of Energy, prices are regulated by the Ministry of Finance (i.e., the Anti-Monopoly Committee); for international sales, the terms are based on negotiated contracts. Uzbekneftegaz manages the earnings and disposition of foreign exchange for the underlying entities. The association also arranges and provides guarantees for credit extended by banks to its underlying entities; it reports that it has not had a problem in bank loan defaults.

Uzkhlopkopromsbyt (cotton processing and marketing): Uzkhlopkopromsbyt was established by Presidential decree in 1992; it was the Ministry of Cotton Processing. It is not registered under the Company Law. The CEO has the rank of minister and is a member of the Cabinet of Ministers; he is appointed by the Cabinet of Ministers. There are about 130 cotton ginneries as members of Uzkhlopkopromsbyt; each has 3-4 cotton producers associated with them. In total, its member firms employ 60-70,000 persons. All of the ginneries are reported to be joint-stock companies. For the typical ginnery, the state owns 51% of the shares, employees own 26%, and individuals own the remaining shares. For the state shares, Uzkhlopkopromsbyt represents the state on the ginneries' boards. There is a plan for state ownership to decrease to 25%. Uzkhlopkopromsbyt reports that at present it has two main objectives: First, it provides credit to cotton producers from a special fund established by a Presidential decree to finance the annual cotton-picking campaign; producers pay back the credits through selling cotton to Uzkhlopkopromsbyt at predetermined prices, which may or may not contain a premium compared to world prices. Second, Uzkhlopkopromsbyt provides transport and storage services as well as equipment and technical assistance to ginneries. Uzkhlopkopromsbyt does not engage in the export of cotton; it only has the rights to sell to domestic factories (the Ministry of Foreign Economic Relations handles cotton exports). Uzkhlopkopromsbyt was unable to provide information on its budget; the fees it collects are determined by the price premia paid to ginneries, which it estimates as 2% of the price, but it varies across producers. Membership in the association is not obligatory; however, there are no cotton producers that are not in its membership.

Source: Author's interviews

Associations are headed by individuals that have the rank of Minister, serve as members of the Cabinet of Ministers, attend meetings of the Cabinet and regularly report to the Cabinet on the sector's output, production plans, profitability and other indicator's of performance. Some associations have set up their own banks; most have not. Associations are governed by "boards of directors" (or similar groups) comprised of sector 'insiders'. Staff of an association typically serve on the boards of their underlying entities, representing the State's interests on the boards' decisions. While most association members are SOEs, some associations have members that are privatized firms, new private entrants, and foreign joint ventures; however, it is widely perceived that most associations are not in favor of their members being privatized and that they act to forestall such privatizations. It is also widely perceived that associations act to undercut competitively the PIFs; for example by arranging for subsidized credit or energy inputs to create an unlevel playing field. Although in many cases an association may hold less than a 25% share in an underlying entity—the size of share ownership required under the Company Law to block shareholders' decisions—by dint of the association's control over other facets of the sector's operations, it can exercise control over an entity disproportionately to its ownership. Managers of the underlying firms still perceive of the associations as their sector ministries; although the name of their supervisory authority has changed, the firms' managers see no effective change. While membership in an association is not legally mandatory, in practice, virtually every firm operating (or seeking to operate) within a given sector is (or becomes) a member of the sector's association. Estimates vary as to the size of membership fees charged, but they appear to be on the order of 10%-20% of profit.

Corporate governance incentives and structures appear stronger in the private sector. In 1999 there were 84,900 private firms in Uzbekistan; as noted earlier, this accounts for about 45 percent of the total number of registered firms in the country. Most of these firms are of small and medium size; relative few are corporations under the Company Law. Improvements in corporate governance are most pronounced in the PIFs. But these entities are not yet of sufficient scale in the economy to effect fundamental behavioral changes in business practices, nor induce systemic competition economy-wide. Indeed the role of the PIFs appears to be on the decline, in part because of the continued dominance of the trade associations.

Separating Government from Business. Enhancing corporate governance practices in Uzbekistan can come about through several related reforms. First, in order to engender real separation between government and business—a critical objective for clarity of corporate governance incentives—the 56 "associations" should undergo fundamental reorganization and reform. This would include (i) their corporatization and becoming *bona fide* commercial companies—under the strictures of the Company Law. In other transition economies where SOEs have been corporatized, there has been improved enterprise performance. At the same time, (ii) the associations should employ 'outsiders' and non-State, non-government representatives on their boards of directors and in senior management positions, including but not limited to, the chief executives. Heads of associations would no longer serve as "ministers", sit on the Cabinet of Ministers, nor have membership in the Government. And, in time, (iii) the State should divest of its ownership shares in all but a very select few associations, essentially (a) those where there are *bona fide* natural monopoly structures (see below) and (b) *bona fide* military or national security activities. If the Government is indeed interested in compelling a stronger competitive environment for private business development in Uzbekistan, continued State ownership on the scale that currently exists in the associations will be highly problematic. At a minimum, the Government will need to come to the realization that if it is interested in enhancing the use-value of State assets, there is a very strong case for reducing State ownership to a passive, minority position and providing for professional independent managers to serve as custodians and control association enterprise operations.

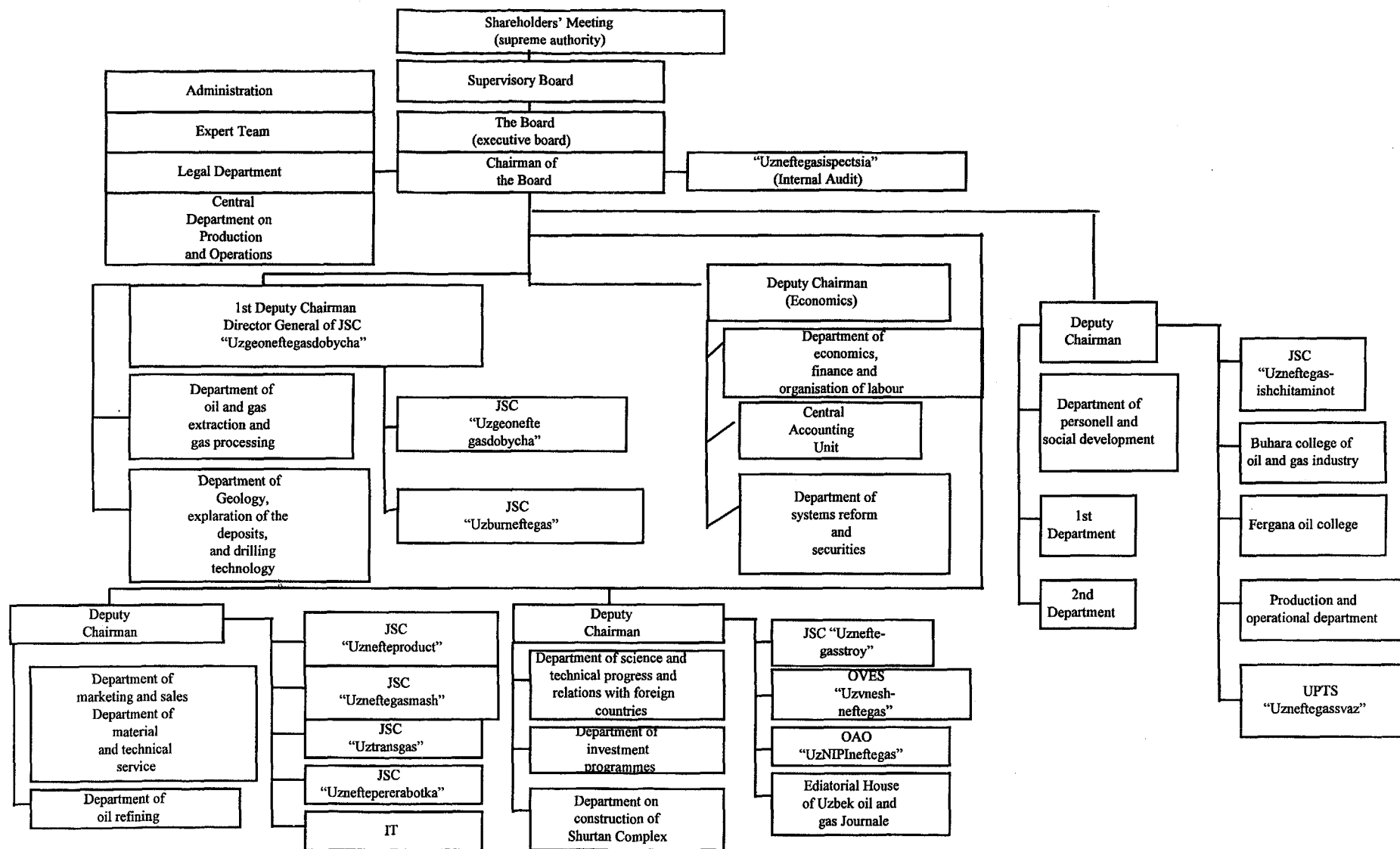


Figure 1: Organizational Chart of Uzbekneftegaz

Simplifying Holding Company/Group Structures. Second, simplification, rationalization and competitive restructuring of holding group structures should also be carried out. In the associations where such holding company-type structures exist, they appear (relative to international practice) to be not only unduly complex and non-transparent—thus making the task of utilizing internal control mechanisms for effective information gathering/monitoring of management and employee activities difficult—but arguably are also not structured to maximize economies of scale and scope, thus engendering increased operational and production costs and undermining competitiveness. Different associations will require different types of simplification, rationalization and restructuring, and there is no uniform model that should be implemented. Carrying out the two reforms indicated above will help reorient the incentives to those who should be in a better position than is currently the case for deciding what type of restructuring makes the best commercial sense.

Fostering Competitive Rivalry. Third, by the same token, stronger external competitive discipline on the associations will also help compel the restructuring that is desirable. In part, this means following through with the other reforms suggested in the sections above for improving the overall competitive environment in Uzbekistan. This should help encourage new private business entry and provide for a more fertile environment for PIFs to challenge the market domain of the associations. The example set by China of allowing non-state firms to challenge SOEs is instructive in this regard.¹¹ But it also means that other external checks and balances need to be put in place. In particular, commercial and risk-based banking and financial sector practices are required to exert effective credit and debt collection discipline on business performance. Similarly, application of international accounting standards (IAS) and published regular audits of such financial accounts carried out by independent auditors will also be essential.

VII. COMPETITIVE RESTRUCTURING AND REFORM OF INFRASTRUCTURE MONOPOLIES

Like other transition economies, Uzbekistan has adopted the nomenclature of “natural monopolies” for specific sectors of the economy—those that typically encompass large firms that provide infrastructure services on a public, economy-wide basis, i.e., services that are either basic inputs to other businesses or basic provisions for the livelihood of households. Rooted in the earlier Soviet regime, the designations of many such monopolies as “natural” have less to do with the true economic structure of markets than with previous notions of command and control and central planning, as enshrined in statutory criteria.

Under Uzbekistan law—for example, the law “On Competition and Restriction of Monopoly Activity in Commodity Markets”—at least the following sectors are formally defined as “natural monopolies”: (i) production of oil, gas condensate and natural gas; (ii) coal mining; (iii) pipeline transport of oil, refined petroleum and natural gas; (iv) generation, transmission and distribution of electric power and heat; (v) railway transport; (vi) port services; (vii) airport services; (viii) telecommunications; (ix) postal services; and (x) water supply and sewage. Table 2 indicates the number of “natural monopoly” suppliers in each sector as indicated by the Anti-Monopoly Committee as of October 1999.

¹¹ See Broadman (1999).

**Table 2: Uzbekistan Enterprises Registered as “Natural Monopolies” at the Republic Level
(as of October 1, 1999)**

Sectors with “Natural Monopolies”	Number of Enterprises
Production of oil, gas condensate and natural gas	7
Coal mining	4
Pipeline transport of oil	1
Pipeline transport of natural gas	2
Generation, transmission and distribution of electric power and heat	48
Railway transport	1
Airport services	12
Postal services	16
Telecommunications	21
Water and sewage	30
Total	142

Source: Uzbekistan Anti-Monopoly Committee

When Monopolies are No Longer “Natural”. International experience shows that policies that stifle the operation of inherently competitive infrastructure sectors, as well as prevent the progression of traditional “natural” monopolies into more competitive regimes, impose costs on society in the form of high consumer prices, poor production efficiency and retarded innovation. Distinguishing between competitive versus noncompetitive infrastructure sectors is thus an important policy issue in designing further transition reform initiatives. In this regard, governments worldwide typically categorize public enterprises into three groups, and this taxonomy provides a useful guide for Uzbekistan policymakers: (a) in “strategic” industries—the national military defense sector, the currency mint, and the mining of rare metals that have national defense applications—there is, with few exceptions, a compelling rationale for state involvement; (b) in “monopoly or quasi-monopoly” industries—usually local-level utilities in the energy, mass transit and communication sectors—the rationale for government involvement, either through direct ownership or regulatory oversight of nonstate-owned service providers, has historically been strong inasmuch as market forces alone can often produce suboptimal results; however, such sectors can evolve to a point where the competitive provision of such services is most efficient, and this outcome has often entailed the divestiture of utility firms to private owners; and (c) in “commercial” industries—most of the manufacturing and services sectors—there is generally little justification for state involvement, as competitive market forces often engender the greatest efficiencies.

The overwhelming majority of industrial sectors in countries around the world today possess underlying organizational structures that are *inherently* competitive. Thus within the typical industrial sector, maximum social efficiency is realized when numerous firms are producing the product (or service); the output share of each firm is not large enough to control the prevailing price in the market; any attempt by a firm to charge an above-market price will produce a loss of consumers or entry by rival

firms eroding any temporary excess profits; and prolonged losses of poorly performing firms will bring on a change of management, a buy-out by new owners, exit or liquidation of the firm. In such “naturally” competitive sectors, artificially restricting the number of firms or output through government intervention, such as by establishing policy barriers to entry or exit, burdensome registration or licensing requirements, or international tariffs and quotas, raises consumer prices, reduces productive efficiency of the firms, and stifles innovation. Society is thus made worse off.

In contrast, there are a limited number of other sectors where society benefits from fewer firms. These “natural” monopoly (or oligopoly) sectors have a special characteristic unique to the product (or service) they are producing, often due to industry-specific technologies: as production expands, the average cost of producing each additional unit declines. In such special situations, it is most efficient to let one or a few firms produce as much as the market demands; indeed too many firms all trying to take advantage of the sector’s inherent economies of scale will result in uneconomic duplication of facilities and chronic losses. This raises the question: doesn’t allowing only one or a few firms to operate in a market simply invite them to take advantage of the opportunity to set prices too high? There are two answers. In some cases, the best solution is to give the firms *exclusive* market franchises *in return* for subjecting their price-setting or profits to regulation. In other cases, the cost of entry and exit by rival firms is relatively low. As a result, the credible threat posed by *potential* competitors exerts a sufficiently strong discipline on the incumbent firm (or firms) to keep prices at competitive levels; these are sometimes referred to as “contestable” markets.

Worldwide, the inherently competitive sectors generally encompass all of manufacturing and many natural resource and services industries; this includes, for example, chemicals; steel; machinery; automobile production; textiles; electronics; oil, gas and coal; and construction. Some utility service industries possess organizational structures that are naturally monopolistic (or oligopolistic). Underground pipeline distribution of natural gas at the city level to residential consumers is a good example; universally, such firms are given market franchises and subjected to regulation. But economic history teaches that many industries thought to be natural monopolies actually go through life cycles; as they mature, technology advances and markets grow, they *evolve* into competitive sectors. Whereas long distance telecommunications or postal services previously were considered “natural” monopolies, today they are inherently competitively structured. The airline industry has also evolved into a contestable sector. Putting in place government policies that either prevent such an evolution or maintain artificial monopolies can inflict sizable costs on society in terms of increased prices; lost output; poor service quality; and reduced innovation.

Competitive Unbundling and Restructuring. These lessons suggest several reform items for Uzbekistan. The first is the need for proactive restructuring and unbundling in state owned infrastructure market segments where (i) monopoly structures are not, or are no longer, “natural” and (ii) the (deregulated) private, competitive provision of utility services with open entry will enhance economic welfare. Sectors where such reforms are most needed likely include coal mining, oil and natural gas production, telecommunications, electric generation and transmission, railways and other forms of long-haul transport, airport services, and postal services. The draft *Program of Formation of a Competitive Environment for 2000-2005* recently tabled with the Cabinet of Ministers too modestly begins to address some of these objectives. The sectoral spread covered in the Program is far too narrow. Moreover, the Program foresees maintenance of price controls on such sectors, where not only should there be entry deregulation but also price deregulation.

Privatization and Competitive Entry. Second, there should be plans developed for the privatization of these entities, utilizing international best practice transparent and competitive case-by-case privatization techniques with the assistance of independent financial advisors. The objective should be to attract new private strategic investors to enhance the operational efficiency of the entities sold.

However, privatization of these infrastructure monopolies should not precede the establishment of effective competition policy and regulatory disciplines so as to prevent simply shifting a public monopoly to a private monopoly.

Regulatory Reform. Third, in the remaining infrastructure monopoly market segments, reforms of regulatory institutions and oversight procedures are needed to bring Uzbekistan's regulatory regime in line with international practice. Indeed this is also an objective on the agenda of the Anti-Monopoly Committee. Specifically actions are needed in this regard along several fronts:

- De-politicization of tariff-setting, entry/exit decisions, service offerings and implementation of other regulatory mechanisms. In part, this will come about through the restructuring of the Anti-Monopoly Committee into as independent agency as suggested above. Use of independent regulators and judges (where necessary) is critical to ensuring impartiality of regulatory decisions. The term/tenure of regulatory officials should be made immune from the political process/cycle.
- Reduction of discretionary behavior in implementing regulations. Achieving this objective will necessitate strengthening the legislation that defines the rules-based regime and enforcing incentives/disincentives for officials to adopt stricter adherence to that regime. Streamlining the decision-making process will also reduce opportunities for discretionary conduct by regulators.
- The content of the regulations should ensure that price, output and investment decisions by service suppliers are both in line with costs and pro-competitive, i.e., that they create a "level playing field" among users so as to not provide for cross-subsidies and unfair advantages, especially between SOEs and private firms.
- Safeguards should be put in place that increase the public transparency and accountability of regulatory decisions. This can be accomplished through regular public hearings where all affected interests can participate, including the regulated entities, their business and residential consumers, workers and the general public. There should also be a transparent appeals process for businesses and consumers who wish to question decisions that have been undertaken.

VIII. CONCLUSION AND SUMMARY

The preceding analysis suggested several areas where Uzbekistan should focus its structural reform agenda in order to enhance the country's enabling environment for business development and growth. It is clear that a better understanding of, and appreciation for the benefits of enterprise competition and how it influences economic growth are needed among senior policy makers, businesses (including banks and the privatization investment funds (PIFs)), and consumers. This can be fostered through better training of officials on the concepts of competition and regulation; use of on-the-ground policy advisors that can bring to bear international experience in implementing competition and regulatory reform policies, including improving the legislative framework; and greater public education through, for example, the creation of non-governmental organizations (NGOs) to communicate the benefits of competition and possibly serve as an ombudsman for consumer rights.

Reform of Uzbekistan's competition policy framework should be devised and implemented within the broader context of the Government's goal of strengthening the overall structural reform program; it should also be linked with the country's macroeconomic policy objectives. Formulation of policies to enhance the business environment should focus not only on fostering the competitive conduct of incumbent firms, but also on (i) reducing barriers to entry by new firms—usually the engines of growth

and employment creation in transition economies and (ii) reducing fiscal and financial system business subsidies—“hardening budget constraints”—and facilitating the restructuring, reorganization and bankruptcy, including where necessary liquidation, of inefficient firms so as to re-channel bottled up assets to new ventures. At the same time, the industrial policy regime should be reformed to be made consistent with the objectives of the country’s competition policy. Similarly, reforms in the areas of foreign exchange liberalization, international trade and direct investment, fiscal and financial sector policy should be informed by, and harmonized with those aimed at improving the competitive business environment.

The analytical capabilities of Governmental and associated institutions also need to be considerably enhanced to carry out on a systematic and regular basis and in line with international practice, independent economic assessments of Uzbekistan’s industrial market structure and determinants of enterprise conduct and performance. To date, only a handful of major analyses of Uzbekistan’s industrial structure has been undertaken; and most have been on a sectoral basis. Moreover they have generally focused on the narrow issues of competition as defined by current statutes, such as legally defined market shares. Rather, what is needed to inform effectively Government competition policy-making consistent with promoting the public interest are: (i) comprehensive independent assessments of product and geographic market boundaries, as determined by economic forces so as to accurately gauge market structures; (ii) analysis of how the structure of markets (e.g., extent of producer concentration and barrier to entry) influences business performance and economic welfare; and a focus on not only specific sectors but also on cross-sectoral market structures, such as horizontal and vertical integration.

In order to create a credible competition “champion”—one with teeth—within the Government, the organization, structure and functions of the existing authority responsible for competition and regulatory policy-making and enforcement should be transformed into an independent agency, reporting directly to the Prime Minister. The current Anti-Monopoly Committee is an outgrowth from the earlier Committee on Prices (hence its reliance on price controls as a competition policy instrument), and is part of the Ministry of Finance, with a Deputy Finance Minister serving as its Chairman. To effect greater public commitment to implement competition policy in a de-politicized fashion, reduce apparent conflicts of interest, and have the clout to deal with powerful vested interests, both on an inter-agency basis and within the economy at the republic and local levels, there is a need to break from the past and reinvigorate the agency with a new mandate and “corporate culture”. There is not a single model for restructuring of the agency, but international practice suggests a set of principles upon which the agency should operate, including, but not limited to: decisions should be rules-based; the entity’s budget should be financially autonomous from other ministries; there should be a transparent appeals process for consumers and businesses, including public hearings; the agency should have autonomous legislative authority; and the agency’s performance should be subject to regular public monitoring to ensure the public interest is protected.

Corporate governance incentives and institutions should be strengthened and brought in line with market-based principles and international practice (for example, the new OECD corporate governance guidelines) to engender greater transparency and accountability. Currently, sound corporate governance practices are blunted because of ill-defined organizational structures and institutions, contradictory lines of authority, and weak disciplines/checks and balances, especially in the management of State assets. As epitomized in the case of the 56 “trade associations”, it appears there is often little distinction between the role of government as policy maker and regulator, on the one hand, and business shareholder (owner) and manager, on the other: as former sector ministries, these holding group entities bear little resemblance to *bona fide* companies, are still headed by individuals that serve on the Cabinet of Ministers, and are governed by boards of directors comprised of ‘insiders’. Corporate governance incentives and structures appear stronger in the nascent private sector, especially the PIFs, but these entities are not yet of sufficient competitive scale in the economy to effect fundamental behavioral changes; indeed the role of the PIFs

appears to be on the decline, despite the growing private sector. Generally, enhanced corporate governance could be brought about through (i) corporatization (under the company law), privatization/divestiture and competitive restructuring of “associations” in order to engender real separation of government from business; (ii) use of outsiders and non-state representatives on boards of directors and senior management; (iii) commercial and risk-based banking and financial sector practices that exert effective credit discipline on business performance; and (iv) application of international accounting standards and published regular audits of financial accounts carried out by independent auditors.

Finally, infrastructure monopolies should be subject to systemic restructuring and unbundling in market segments where monopoly structures are not, or are no longer, “natural” and the (deregulated) private, competitive provision of utility services with open entry enhances economic welfare. In the remaining infrastructure monopoly market segments, reform of regulatory institutions and oversight procedures is needed to de-politicize tariff setting and implementation of other regulatory mechanisms; ensure that price, output and investment decisions by service suppliers are pro-competitive (i.e., create a “level playing field” among users); and increase public transparency and accountability. The plethora of so-called “natural monopolies” in Uzbekistan stems less from application of economic criteria than of old style statutory designations; with the development and expansion of markets, as well as advances in technologies, increasing types of utility services, such as telecommunications and electric generation (among others), when provided through competitive multiple suppliers, rather than protected single suppliers, offer the best chances for cost-based prices, high service quality and reliability, and innovation. In most utility segments, then, the bias should shift towards regulation by market forces rather than by administrative means; however, privatization of infrastructure monopolies should not precede establishment of effective competition policy and regulatory disciplines so as to prevent simply shifting a public monopoly to a private monopoly. Reform of regulatory mechanisms should be keyed to strengthening and streamlining the rules-based framework; enhancing safeguards to ensure that decisions regarding rate-making and service offerings are impartial and independent; providing for the tenure of regulatory officials to be immune from the political process; establishing a transparent appeals process for consumers and businesses, including public hearings.

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